

Office of the
Auditor General
of Canada

Annual Audit Manual



Table of Contents

Annual Audit Manual

Foreword

Introduction

- Preface (*para. 1*)
- How to Use This Manual (*para. 5*)
- Methodology Support (*para. 8*)
- Context of our Annual Audit Practice (*para. 10*)
- Organization of this Manual (*para. 11*)

1 General Audit Management Issues

- Management of Risk — Roles and Responsibilities (*para. 1.1*)
- Our Responsibilities as Legislative Auditors (*para. 1.12*)
- Communication (*para. 1.29*)
- Consultation (*para. 1.33*)
- Differences of Professional Opinion (*para. 1.39*)
- Sufficient and Appropriate Audit Evidence (*para. 1.44*)
- Supervision and File Review (*para. 1.47*)
- The Audit of the Public Accounts of Canada (*para. 1.51*)
- Access to Audit Files (*para. 1.57*)
- Guidance and Tools (*para. 1.60*)

2 Approach to Annual Audits

- Conceptual Overview for Conducting the Audit (*para. 2.1*)
- Risk and Audit Assurance (*para. 2.2*)

3 Strategic Planning

- Audit Objectives — Terms of Engagement (*para. 3.1*)
- Knowledge of the Entity's Business and Risks (*para. 3.24*)
- Materiality and Ultimate Risk (*para. 3.55*)
- Understanding the Entity's Control Environment and Control Systems (*para. 3.64*)
- Assessment of Inherent Risk (*para. 3.77*)
- The Strategic Plan (*para. 3.86*)
- The Strategic Plan Document (*para. 3.97*)

4 Detailed Planning and Testing

- General (*para. 4.1*)
- Compliance with Authorities and "Other Matters" — Crown Corporations and Other Entities (*para. 4.5*)
- Compliance with Authorities — Public Accounts (*para. 4.10*)

Table of Contents

Reliance on Processing Controls (*para. 4.21*)
 Reliance on Management and Monitoring Controls (*para. 4.28*)
 Analytical Procedures (*para. 4.33*)
 Substantive Tests of Detail (*para. 4.39*)
 Other Evidentiary Matters (*para. 4.49*)

5 Reporting

Evaluating Audit Results (*para. 5.1*)
 Evaluating Compliance with Authorities and "Other Matters"
 (*para. 5.5*)
 Reference Assistant Auditor General Review (*para. 5.18*)
 Annual Audit Practice Review (*para. 5.22*)
 Sensitive Issues (*para. 5.28*)
 Report Clearance Memorandum (*para. 5.29*)
 Signing the Auditor's Report (*para. 5.35*)
 Review of the Annual Report (*para. 5.36*)
 Reporting to the Audit Committee (*para. 5.40*)
 Management Letters (*para. 5.43*)

6 Consultation

Auditor General on Sensitive Issues (*para. 6.3*)
 "Reference" Assistant Auditor Generals (*para. 6.5*)
 The Annual Audit Practice (AAP) Team (*para. 6.9*)
 Involvement of Specialists — General (*para. 6.19*)
 Information Technology (IT) Audit Specialists (*para. 6.20*)
 Financial Instruments (FI) Accounting and Audit Specialists
 (*para. 6.25*)
 Legal Services (*para. 6.27*)
 Consultation and the Annual Audit of the Public Accounts of
 Canada (*para. 6.32*)
 The Auditor General's Independent Advisory Committee
 (*para. 6.32*)
 Documenting Consultation (*para. 6.35*)

7 Practice Expectations Common to All Product Lines

Introduction (*para. 7.1*)
 Audit Management (*para. 7.5*)
 People Management at the Team Level (*para. 7.55*)
 Continuous Improvement (*para. 7.60*)

8 Quality Management System (QMS)

Elements of Our Quality Management System (QMS) (*para. 8.1*)
 Reasonable Assurance (*para. 8.3*)
 Ongoing Improvement of the Quality Management System
 (*para. 8.5*)



Annual Audit of the Public Accounts of Canada, the Territories, Crown Corporations and Other Entities

Foreword

The Annual Audit Manual is one of three product line manuals resulting from the most recent update of the Comprehensive Auditing Manual (CAM). The purpose of the update was to:

- delay the CAM to recognize the unique requirements of each product line;
- clarify responsibilities and increase delegation to Assistant Auditors General and teams;
- clearly differentiate between required practice and areas where professional judgement can be exercised; and
- take advantage of the capability of electronic tools (Intranet), and move away from paper-based guidance.

This manual covers all annual audits, including those carried out on the Public Accounts of Canada, the Territories, Crown corporations and other audit entities. The other two manuals are the Value-for-Money Audit and Special Examinations Manuals. Each manual is supported by functional guidance and other procedures and tools specific to the product line. The delayed CAM will henceforth consist of these three product manuals together with the Office's Strategic Framework and Code of Professional Conduct.

The Annual Audit Manual has been built around professional standards and Office policies that auditors must meet to produce a high-quality audit. The Manual has a strong quality orientation based on current thinking and practice in first-class professional organizations. It provides a clearer picture of the standard of quality expected from staff and encourages professional judgement.

The Annual Audit Manual is the product of extensive consultations with practitioners in the Office, the Practice Development Committee and Office specialists including functional responsibility leaders as well as external consultants.

The Manual is expected to be a focal point for the continuous improvement of our annual audit practice. Our knowledge and experience with annual auditing continue to expand and evolve; so will this Manual. If you wish to suggest additional issues that should be covered, or to offer any other comments or suggestions for improving the Manual, you may contact the Annual Audit Practice team and/or the Professional Practices and Review Group.

Annual Auditing — A Proud History

The Office's annual audit practice dates back more than 120 years to the appointment of Canada's first Auditor General, John Lorn McDougall, in 1878. His appointment followed passage of the *Act to provide for the Better Auditing of the Public Accounts*, which was given Royal Assent on 10 May 1878. The *Act* was based on the desire of legislators to "free the auditing of the public accounts from any interference on the part of the administration" by appointing an independent Auditor General who would be an officer of Parliament. The Minister of Finance told the House of Commons that the Auditor General's responsibilities would include examining the accounts and vouchers of government expenditures, and reporting to Parliament on "any deficiencies in the appropriation accounts of sums which he thinks are not properly authorized in his opinion." That is, the Auditor General was to make sure that public funds were spent within the limits and for the purpose approved by Parliament.

Canada's first Crown corporations came into being before Confederation, but it was not until the introduction of the *Financial Administration Act (FAA)* in 1951 that efforts were made to make these entities more accountable to Parliament. The FAA required each Crown corporation's auditor (which was not necessarily the Auditor General) to report on the financial statements and accounting practices of the corporation. In addition, the auditor was required to "call attention to any other matter falling within the scope of the auditor's examination that in his/her opinion should be brought to the attention of Parliament." At the same time, this responsibility to report "other matters" was extended to cover departments and agencies by the *FAA*.

The passage of time, the *Auditor General Act* of 1977 and subsequent amendments to the *FAA* have further strengthened the role of the Auditor General in conducting and reporting the results of the annual audits of the Public Accounts of Canada, the Territories, Crown corporations and other entities. The fact that Parliament and the Territorial governments continue to look to the Auditor General for independent advice and assurance is a testimony to its confidence in the quality of our work.

The policies, procedures and guidance outlined in this Manual are part of the Office's *Quality Management System (QMS)*. The *QMS* is designed to provide the Office with reasonable assurance that it conducts high quality audits in

Foreword

accordance with applicable legislative requirements, professional standards and Office policies. In other words, our *QMS* is intended to help us continue a proud tradition of serving the public interest through the assurance we provide from our annual audit practice.

L. Denis Desautels, FCA
Auditor General of Canada
11 March 1999

Introduction

Preface

1. The Office currently has four product lines: annual audits of the financial statements of the Government of Canada (Public Accounts of Canada), the Territories, Crown corporations and other entities; Special Examinations of Crown corporations; value-for-money (VFM) audits of departments and agencies and studies; and environment and sustainable development audits and studies. The Practice Development Committee of the Office works with staff to develop and approve policies, standards and expected practices for each product line, with the objective of ensuring that these standards are maintained at the highest professional level.
2. The Annual Audit Manual has been prepared to explain the Office's *Quality Management System* for conducting annual audits. The Manual includes information about all aspects of the *Quality Management System* for Annual Audits, but focuses on conduct of the audit and consultation. The Office policies, methodology and supporting guidance and tools applies to all annual audits, including the Public Accounts of Canada, the Territories, Crown corporations, and other separate opinion work.
3. The Manual has been written primarily to meet the specific needs of annual audit practitioners. It describes the conceptual underpinnings of the Office's annual audit methodology, explaining in broad terms how these audits should be planned, conducted and reported. The Manual refers readers to some of the various audit tools and other guidance that exist, providing only minimal "how to" information. It does, however, identify additional sources of guidance that exist to help meet the needs of annual audit staff.
4. This Manual does not include an exhaustive description of auditing theory. Rather, it is intended as an efficient resource to explain the principles underlying the Office's approach to conducting annual audits, including the audit of compliance with legislative authorities. The application of the methodology in the context of specific annual audits is left to the professional judgement of the responsible audit Principal and his/her audit team.

How to Use This Manual

5. The Office has developed a quality management system to guide staff in managing annual audits. This system is designed to provide reasonable assurance

that our annual audits are conducted in accordance with applicable legislative requirements, professional standards and Office policies.

6. There is an expectation that the framework for conducting annual audits described in this Manual will be followed by all Office staff. However, while it is recognized that no system is applicable in every circumstance, exceptions to Office policies, methodology and supporting guidance and tools should be rare. In these rare situations, the audit Principal should obtain the concurrence of his/her Assistant Auditor General, and that of the Deputy Auditor General (Operations) or the Auditor General [as considered appropriate in the circumstances].

ANNUAL AUDIT POLICY

Staff (Office employees and contractors) should comply with Office policies and Generally Accepted Auditing Standards and apply Office methodology. The audit Principal should obtain the approval of the responsible Assistant Auditor General, where this is considered inappropriate or impractical.

7. For the annual audit of the Public Accounts of Canada, if it is considered inappropriate or impractical to comply with Office policies and Generally Accepted Auditing Standards and apply Office methodology, the entity team Principal should obtain the approval of the Public Accounts team Principal. The Public Accounts team Principal should then obtain the approval of the Assistant Auditor General responsible for the audit of the Public Accounts of Canada and the Auditor General and/or Deputy Auditor General.

Methodology Support

8. The Functional Responsibility Leader (FRL) for Crown corporation audits, under the supervision of the Practice Development Committee, is responsible for the ongoing support of the annual audit policies, methodology and supporting guidance and tools described in this Manual. Questions regarding interpretation or the application of particular aspects of the Office's approach should be directed to the FRL for resolution. Equally, innovative practices and suggestions for improvement are appreciated, and will be used to enhance the methodology and to improve practice throughout the Office.

9. For additional information, guidance and/or support, please contact the following:

FRL, Annual Audits

Mary Clennett

Principal, Annual Audit of the Public Accounts of Canada

John Hodgins

Context of our Annual Audit Practice

10. The Office's *Quality Management System* has been developed taking into account the unique environment in which we operate. This environment is comprised of a number of key characteristics that have shaped our annual audit practice. As noted in the *Foreword* section to this Manual, some of these characteristics have historical significance. All have influenced the development of Office policies and practices. These policies and practices are outlined in more detail throughout this Manual.

KEY CHARACTERISTICS	IMPACT ON OUR PRACTICE
Legal Mandate • The legal mandate of the Auditor General is generally described in the <i>Auditor General Act</i>. • However, other <i>Acts</i> of Parliament may include references to annual audits and other specific duties to be undertaken by the Auditor General. • The wording used in these <i>Acts</i> to describe our responsibilities is not always consistent.	• As a legislative audit office, it is important to ensure we have a proper legal basis for all of our annual audit work. Consultation with legal services, where appropriate, helps to ensure a proper legal basis exists for our work. • Terms of engagement are dictated by legislation, but we strive to be as consistent as possible across our portfolio. Consultation with our Annual Audit Practice team contributes to achieving consistency. • Communicating with senior management of audit entities is important to ensure that we both share a common understanding of the terms of our annual audit engagements.
Appointment of the Auditor General • The Auditor General is appointed for a ten year term by the Governor in Council. • The Office's independence is established in the <i>Auditor General Act</i>.	• We have a high degree of independence, and are subject to few of the conditions that exist for public accounting firms that might jeopardize our independence. However, we do need to avoid situations involving potential conflict of interest, as outlined in the Office's <i>Code of Professional Conduct</i>. • Except in limited circumstances, the Office does not charge and/or recover fees. Nevertheless, we still have an obligation to be economical, efficient and effective in our annual audit work.

that our annual audits are conducted in accordance with applicable legislative requirements, professional standards and Office policies.

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KEY CHARACTERISTICS

IMPACT ON OUR PRACTICE

Legal Mandate

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| <ul style="list-style-type: none"> • The legal mandate of the Auditor General is generally described in the <i>Auditor General Act</i>. • However, other <i>Acts</i> of Parliament may include references to annual audits and other specific duties to be undertaken by the Auditor General. • The wording used in these <i>Acts</i> to describe our responsibilities is not always consistent. | <ul style="list-style-type: none"> • As a legislative audit office, it is important to ensure we have a proper legal basis for all of our annual audit work. Consultation with legal services, where appropriate, helps to ensure a proper legal basis exists for our work. • Terms of engagement are dictated by legislation, but we strive to be as consistent as possible across our portfolio. Consultation with our Annual Audit Practice team contributes to achieving consistency. • Communicating with senior management of audit entities is important to ensure that we both share a common understanding of the terms of our annual audit engagements. |
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Expectations of a Legislative Audit Office

- The Office has an obligation to Parliamentarians to bring to their attention instances where our audit entities have not been in compliance with legislative authorities in all significant respects.
- The Office is expected to bring to the attention of Parliamentarians any "other matters" that the Office believes they should be aware of.
- As a legislative audit office, our work can, at times, involve politically sensitive issues that may increase our audit risk.
- Our annual audit work should be consistent with the expectations of Parliament. Addressing compliance with authorities and "other matters" is an integral part of the design, execution and reporting phases of every annual audit.
- We provide an opinion in all of our auditor's reports that addresses compliance with authorities and "other matters", either directly or on an exception basis. This opinion has no direct counterpart in private sector practice. In the Public Accounts of Canada, this information is included in the *"Observations by the Auditor General on the Financial Statements of the Government of Canada"*, which we refer to in our auditor's report.
- Consultation with internal specialists and Office senior management helps to ensure sound judgement is exercised in planning, executing and reporting the results of our annual audit work. Consultation and senior management involvement also contributes to ensuring our work meets the needs and expectations of legislators, and that we communicate our findings clearly and succinctly.

Audit Entities

- There is little change from year to year in the portfolio of audit entities for which the Office performs annual audits.
- Because of this fact, the Office has considerable experience with most of the entities we audit.
- In some entities the Office performs "special examinations" or other types of audit work which further enhance our understanding of these entities.
- There are typically few, if any, comparable entities in the private sector.
- Even though we generally have a long history with most of our audit entities, our environment is a dynamic one. Maintaining a sound knowledge of the entity's business and risks is an ongoing activity that should be visible throughout all phases of our annual audit work.
- With many "one-of-a-kind" entities, we may need to consult with internal and/or external specialists to acquire sufficient knowledge and understanding of specialized industries and/or unique industry accounting practices.

Professional Standards

- The CICA Handbook was not written expressly taking into account the unique features of many public sector entities that we audit.
- Public sector accounting standards are relatively new and continue to evolve.
- Consequently, application of professional standards in our environment requires significant judgement that should be applied consistently across our client base.
- We comply with professional standards, applied on a basis appropriate to the circumstances.
- We frequently face unique problems for which there is little existing guidance. Consultation with internal and/or external specialists is necessary to reach sound, professionally defensible positions on these issues.
- Application of professional standards in our environment requires significant judgement that should be applied consistently across our client base. Consultation with the Annual Audit Practice team contributes to achieving this consistency across the Office.

Office Size, Organization and Staff

- The Office has a relatively small number of professional staff that work closely together.
- There are six audit groups within the Office in which annual audits are conducted.
- The audit of the Public Accounts of Canada is the largest annual audit in the country.
- We have developed a corporate culture built on consultation and consensus-building. The Office values this culture, and has established policies and procedures that encourage and support these types of behaviours.
- Completing the audit of the Public Accounts of Canada requires teamwork and cooperation of staff throughout the Office.

Office Methodology and Practices

- The Office has an established methodology for conducting annual audits.
- Our methodology evolves with changes in the practices of the private sector and as a result of innovation within the Office.
- We strive to build in quality throughout all phases of the annual audit.
- The methodology described in this Manual applies to the annual audits of the Public Accounts of Canada, the Territories, Crown corporations and other entities.
- As part of our "continuous learning" initiatives, the Office regularly surveys developments in the private sector.
- We work with private sector auditors on some engagements. On those engagements, we need to satisfy ourselves that the work of the joint auditor meets the quality standards of our Office.
- We emphasize "real-time" supervision and coaching that builds in quality as the audit unfolds. We expect file reviews to be completed on a timely basis, their main objectives being to confirm that quality work has been done. We recognize that building quality in is more efficient than inspecting it in after-the-fact.

Organization of this Manual

11. The Annual Audit Manual consists of nine distinct sections.

SECTION	MATTERS DISCUSSED
Introduction	The defining characteristics of our environment and how they have helped shape our practice
General Audit Management Issues	Broad audit management issues that have relevance to all phases of our annual audit work
Approach to Annual Audits	Conceptual overview to the Office's overall approach for conducting annual audits
Strategic Planning	The Office's expectations leading to the completion of the Strategic Plan for the audit
Detailed Planning and Testing	The four different sources of audit assurance (reliance on processing controls, reliance on management and monitoring controls, analytical procedures, substantive tests of details), and other evidentiary matters
Reporting	The process of evaluating audit results, finalizing the auditor's report and communicating the results of our work to the audit entity and its audit committee (or equivalent)
Consultation	The Office's expectations regarding when consultations should take place
Practice Expectations Common to all Product Lines	Office policies and expectations in areas common to all of the Office's audit work such as access to information and conflict of interest
The Office's <i>Quality Management System</i> for Annual Audits	Key features of the Office's <i>Quality Management System</i> for annual audits

1

General Audit Management Issues

Management of Risk — Roles and Responsibilities

Introduction

1.1 The Office's *Quality Management System* is designed to provide reasonable assurance, in light of the likelihood and magnitude of potential risks, that we conduct annual audits in accordance with applicable legislative requirements, professional standards and Office policies. Reasonable assurance recognizes that the cost of managing risk should not exceed the benefits likely to be derived. As such, reasonable assurance involves achieving a satisfactory level of confidence under given considerations of costs, benefits and risks — it does not mean absolute assurance of all aspects of quality for each individual audit.

Reference Assistant Auditor Generals

1.2 Where the Office believes that a particular annual audit has characteristics generally associated with higher risk, a Reference Assistant Auditor General (AAG) may be appointed. Reference Assistant Auditor Generals have no direct involvement or responsibilities on the audit(s) to which they are assigned. They should be involved at critical points in strategic planning and reporting phases of the audit to, among other things, help ensure that risks have been identified and evaluated appropriately. The experience and relative independence of these Reference AAGs contribute to sound planning decisions.

1.3 The *Consultation* section of this Manual discusses more broadly how consultation is expected to be used by audit teams to mitigate risk.

Delegation

1.4 Although the Office has not formally classified each of its audits in terms of key risks they pose, all staff are expected to use their judgement in applying the Office's *Quality Management System* to the particular engagement at hand. In particular, audit Principals should consider the aggregate impact of the identified risk factors and any other relevant information on each engagement in forming judgements about how authority should be delegated and in the assignment of responsibilities to individual team members. The decisions made by the audit Principal influence how the audit is managed and the extent to which authority is to be delegated upward, downward or follow the status quo.

Risk Factors That May Apply

1.5 There are three broad categories of risk that should be taken into account by the audit Principal. These are:

- parliamentary interest;
- engagement-specific factors; and
- office internal factors.

Parliamentary Interest

1.6 Audit entities may attract the attention of Parliament for a variety of reasons. This interest could arise from:

- legislative changes affecting the entity;
- matters raised during "Question Period";
- letters to the Office from Members of Parliament;
- media attention; and
- partisan debate.

1.7 Parliamentary interest would be taken into account when determining the inherent risk associated with the related components and/or authorities.

Engagement-Specific Factors

1.8 There are a variety of engagement-specific factors that may, individually or collectively, point to the existence of risks that should be considered in conducting the audit. These risk factors would normally be taken into consideration in making preliminary decisions for components during strategic planning, and would include:

- existence of high value transactions, financial statement components or contingent liabilities;
- operating in a specialized industry, or in an industry undergoing significant changes;
- significant business risks being faced by the entity;
- past financial performance (good or bad);
- existence of significant accounting estimates involving considerable management judgements or estimates;
- weak accountability regime in the entity or in the relationship with the responsible Minister;
- existence of accounting standards unique to the industry;
- significant changes in one or more accounting policies adopted by the entity;
- strained client relations;
- unresolved issues identified in previous years;

- sophistication of accounting and management information systems;
- management integrity, turnover, and/or bias;
- joint audit engagement; and
- existence of legislative authorities that may be difficult to comply with.

Office Internal Factors

1.9 There may also be factors internal to the Office that could affect the degree of risk associated with the engagement. These include:

- significant changes planned in the audit approach;
- experience of the team and continuity of staff;
- reporting deadlines; and
- availability of specialists, where required.

Impact of Risk Factors

1.10 Where risk is significantly lower or higher than the norm, it may be appropriate for the audit Principal to modify his/her approach to the engagement. For example:

The presence of conditions indicating higher risk to the Office would suggest the need for such actions as:

- increased involvement by the Principal and the responsible Assistant Auditor General in key aspects of the audit;
- more extensive consultations with internal and/or external specialists; and/or
- assembling a more senior and experienced audit team.

Conversely, the presence of conditions suggesting lower risk to the Office may indicate there could be:

- increased delegation to more junior staff; and/or
- less involvement with consultants and/or specialists.

For example, in lower risk engagements the following actions might be appropriate:

- the responsibilities normally assigned to the audit Principal could be delegated to an experienced Director;
- the degree of involvement by the Principal in key aspects of the audit could be reduced; and
- the responsibilities normally assigned to a Director could be delegated to an experienced audit senior.

1.11 The audit Principal would normally ensure that his/her plan(s) for managing the risks associated with the engagement are discussed with the responsible Assistant Auditor General and, where one exists, the reference Assistant Auditor General.

Our Responsibilities as Legislative Auditors

A Government Accountable to Parliament

1.12 The people's right to control how their taxes are spent is one of the cornerstones of democratic government. In Canada, like other parliamentary democracies, this control is carried out on behalf of citizens by their elected representatives, the Members of Parliament.

1.13 The government of the day must obtain the permission of Parliament before it can collect, borrow or spend money. After it spends tax dollars, the government must also be able to show that it spent the correct amount, for the purposes approved by Parliament. This obligation of government to answer for its actions is called accountability.

1.14 Over the years, a process has developed to hold the government to account. The government must report fully on its performance by submitting to the House of Commons:

- the annual spending plans of each department;
- reports on the past year's activities; and
- annual financial statements showing all federal spending, borrowing, and taxing, known as the Public Accounts of Canada.

1.15 These documents are intended to provide Members of Parliament with the information needed to hold the government to account. But one more link in the accountability process is needed: *independent assessment of that information*. Members of Parliament need this impartial evaluation so that they can effectively question or criticize the government on its performance.

1.16 The Auditor General of Canada audits government operations and provides the objective information and advice that helps Parliament to hold the government to account.

The Work of the Office

1.17 The statutory duties of the Auditor General provide him/her with a broad mandate to conduct audits and examinations in order to assess how well the government has managed its affairs. The Auditor General does not comment on policy choices, but does examine how those policies are implemented. Accordingly, the subjects of legislative audit work are varied and include:

- verifying whether expenditures have been made in accordance with legislative authorities;

- assessing the appropriateness of the Government's accounting policies;
- attesting to the financial statements of various government entities;
- identifying constraints to economical, efficient and effective management;
- assessing the quality of financial management and control within government;
- assessing whether procedures are appropriate to ensure an effective check on the assessment, collection and proper allocation of revenue;
- reporting on the management of human resources in government;
- monitoring departmental sustainable development strategies and action plans; and
- identifying instances where expenditures have been made without due regard to economy or efficiency.

1.18 The products of the Office are reports to the House of Commons and to various others including ministers, legislative assemblies, boards of directors and managers. These products include the auditor's reports emanating from the annual audits we conduct.

Compliance with Authority — General

1.19 An integral part of all legislative audit work is the verification that government expenditures, revenues and borrowing are in accordance with legislative authorities. Each year, using various approaches, we perform detailed procedures designed to assess compliance with significant legislative authorities. All instances where we find non-compliance with significant legislative authorities are considered by the Auditor General for reporting to the House of Commons.

1.20 None of the various types of audits undertaken by our Office addresses itself specifically and exclusively to the "authority" dimension. Compliance with authority is a pervasive matter in legislative auditing, and it cannot be divorced from any of the other work that we do. Although the weight given to compliance with authority will vary with the auditor's judgements regarding risk and significance — as will the specific approaches adopted — all of the Office's work should include appropriate consideration of compliance with authority.

Compliance with Authority — Public Accounts of Canada

1.21 A fundamental principle of control over the public purse is that Parliament's authorization is required for the government to spend, borrow and raise revenues. Government programs and activities are given legal effect through enabling legislation, while spending is authorized by appropriation acts (which are further broken down by department into broad categories referred to as "votes"). Borrowing is authorized through borrowing acts, and revenues through legislation such as the *Income Tax Act*.

1.22 Compliance with authority to spend, borrow and raise revenues is a basic principle underlying the government's accounting system and its stated

accounting policies. Compliance with those types of authorities is the principal focus of the authority component of the annual audit of the Public Accounts of Canada.

Compliance with Authority — Crown Corporations

1.23 Corporations named in Schedule III of the *Financial Administration Act*, and their wholly owned subsidiaries, are important vehicles through which the government meets public policy objectives. Public ownership, together with their public policy orientation affects their accountability, management and control requirements. These entities are subject to the provisions of Part X of that *Act* insofar as accounting, auditing and reporting matters are concerned. These provisions require the auditor to express separate opinions on: the fairness of the corporation's financial statements in accordance with generally accepted accounting principles; whether the accounting principles were applied on a basis consistent with that of the preceding year; and whether the transactions that have come to the auditor's notice in the course of the audit are in accordance with specified authority instruments. These instruments are: the requirements of Part X of the *Financial Administration Act*, associated regulations, the charter and by-laws of the corporation or subsidiary, and any directives given to the corporation by the Governor in Council.

Compliance with Authority — Other Entities including Territorial Governments

1.24 Other entities on whose financial statements the Auditor General expresses a separate opinion include departmental corporations, government entities, territorial governments and corporations required by law to publish separate audited financial statements, and other entities the Governor in Council has asked the Auditor General to audit.

1.25 The mandate and objectives for the audit of the financial statements of other entities including territorial governments will depend on the provisions of the legislation or Order in Council appointing the Auditor General. In all cases, it is important that the audit objectives established for the specific appointment reflect the role of the Auditor General as Parliament's (or a Territorial legislature's) auditor and the authorities dimension of legislative auditing.

"Other Matters"

1.26 Auditors of Crown corporations also have a responsibility to report on "other matters" falling within the scope of the audit that, in their opinion, should be brought to the attention of Parliament. The *Financial Administration Act* is silent about the kinds of issues that might constitute "other matters".

1.27 "Other matters" identified during the annual audits of Crown corporations would be addressed in a fifth paragraph of the auditor's report. "Other matters" identified during the annual audit of the Public Accounts of Canada may be considered for reporting as "Audit Notes" in our annual and periodic reports to the House of Commons, pursuant to Section 7(2) of the *Auditor General Act*. "Other matters" identified during the course of the

territorial audits are normally included in a *Report on Other Matters* to the territorial legislative assemblies.

1.28 Subsection 7(2) of the *Auditor General Act* illustrates the types of cases that may be considered of significance and of a nature that should be brought to the attention of the House of Commons, such as instances where:

- accounts have not been properly maintained;
- public money has not been fully accounted for or paid, where required, into the Consolidated Revenue Fund;
- essential records have not been maintained;
- money has been expended other than for purposes authorized by Parliament;
- money has been expended without due regard to economy or efficiency; and
- money has been expended without due regard to the environmental effects of those expenditures in the context of sustainable development.

Communication

General

1.29 Our auditor's report is typically addressed to one or more senior elected officials such as the House of Commons (Public Accounts of Canada), the Legislative Assembly (Public Accounts of the Territories) or the Minister responsible for the entity being audited (Crown corporations and most other audit entities). However, senior management of the entities we audit and, where one exists, the Audit Committee (or an equivalent group) are the corporate bodies we have most day-to-day contact with. These parties also have a direct interest in our work, and often are best suited to making use of the "value added" aspects of an annual audit, such as addressing control weaknesses or other matters of significance we may identify in the course of our work. Accordingly, it is important that they fully understand the annual audit process.

1.30 Communicating with entity senior management is one of the important responsibilities of the audit Principal. He/she should ensure that senior management and the Audit Committee understand the terms of the audit engagement, the expected matters of audit significance and the results of our work. This information should be provided to our clients in a timely manner.

ANNUAL AUDIT POLICY

The audit Principal should communicate with management of the audit entity and, where one exists, the Audit Committee (or equivalent) at key stages of the audit.



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ANNUAL AUDIT POLICY

The audit Principal should communicate with management of the audit entity and, where one exists, the Audit Committee (or equivalent) at key stages of the audit.

1.31 It is important to ensure that the information conveyed is clear, succinct and meets the expectations and needs of those to whom it is addressed. Further, we must be sensitive to the fact that any written communication we have with management may be subject to requests under the *Access to Information Act*. Accordingly, it is appropriate to have all such information approved by the audit Principal and reviewed by the responsible Assistant Auditor General. This review and approval should take place before it is given to the audit entity. Such approvals help ensure that our written annual audit products meet appropriate quality standards.

ANNUAL AUDIT POLICY

All reports and other significant communication with the audit entity (e.g. Reports to the Audit Committee, management letters and other important correspondence) should be approved by the audit Principal and reviewed by the responsible Assistant Auditor General before they are presented to the entity.

Public Accounts

1.32 For the annual audit of the Public Accounts of Canada, the term “audit entity” in the above two Policies has three possible meanings and the policies should be applied as follows:

- *a separate department, agency, Crown corporation or departmental corporation that an entity team is responsible for auditing.* These entities are classified as large, small, micro or separate opinion entities. The entity team Principal and the responsible Assistant Auditor General should communicate with these entities.
- *the Government of Canada, specifically the Treasury Board, Finance and Receiver General who are jointly responsible for preparing the financial statements.* The Public Accounts team Principal and the responsible Assistant Auditor General should communicate with these entities.
- *the Public Accounts Committee (PAC).* The Office views the PAC as equivalent to an Audit Committee for the audit of the Public Accounts of Canada. The Public Accounts team Principal and the responsible Assistant Auditor General should communicate with the PAC.

Consultation

1.33 An important element of every annual audit is the consultation that takes place within and between audit teams and Office specialists. When dealing with complex, unusual or unfamiliar issues, audit teams are expected to refer to authoritative literature and/or seek the assistance of Office specialists with appropriate competence, judgement and authority.

1.34 It is also appropriate to consult with respect to more commonplace situations. For example, it is important that we strive for consistency, to the extent considered appropriate, in such areas as:

- terms of engagement with the audit entity;
- accounting policies;
- compliance with authorities and “other matters”;
- Office positions on issues that are conceptually similar; and
- wording of the auditor’s report.

1.35 Achieving this consistency across our audit practice, with its more than 80 separate opinion annual audits, is beyond the practical capability of individual audit teams. Consequently, we need to rely on individuals with specialized knowledge and experience in these and other areas. Working with these specialists is another aspect of consultation that is important in order to meet the expectations of our *Quality Management System*.

1.36 Informal consultation is also an important element of our practice. This affords teams the opportunity to discuss matters with colleagues having similar audit entities (e.g. pilotage authorities, territorial governments) and /or similar accounting or audit issues (e.g. downsizing, accounting for capital assets). The same principles of consultation can and should be applied to the way staff interact on annual audit teams. Staff should apply the collective knowledge, skills and experience that is available on the team to best advantage in resolving minor difficulties and in completing the audit. Consultation between team members is advantageous not only for reaching sound conclusions, but also for staff development. In this regard, the knowledge and experience of the responsible Assistant Auditor General and, where one exists, the reference Assistant Auditor General, are particularly valuable.

ANNUAL AUDIT POLICY

The audit Principal should consult with internal and external specialists and senior Office staff, as necessary, when dealing with unusual, complex or controversial issues, or other matters requiring specialized knowledge or experience.

1.37 There are a number of specialists within the Office that, depending on the nature of the matter, should be consulted. The specialists most commonly consulted include:

- Annual Audit Practice team;
- Legal Services;
- Information Technology team;
- Financial Instruments team; and
- Reference Assistant Auditor Generals.

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- Annual Audit Practice team;
- Legal Services;
- Information Technology team;
- Financial Instruments team; and
- Reference Assistant Auditor Generals.

1.38 The specific circumstances that should lead to consultation with Office specialists, the expected timing of such consultation and the related Office policies are described in the detailed *Consultation* section of this Manual.

Differences of Professional Opinion

1.39 In any professional organization, differences of opinion may arise from time to time. These are normally the sign of a healthy organization where creative thinking is valued and shared. The Office has a strong corporate culture of collaboration and consensus building which encourages these behaviours.

1.40 Occasionally it is not possible to reconcile diverging opinions on audit matters. These disagreements can exist at many levels of significance, for example:

- in an individual audit section, where there could be differences of opinion regarding, for example, what the key controls are or whether a transaction was processed incorrectly;
- at the component level, for example, whether the detailed audit program provides sufficient, appropriate evidence to allow the auditor to conclude on fair presentation and compliance with authorities;
- at the accounting policy level, for example, whether a particular accounting policy is consistent with generally accepted accounting principles for an entity in a specific line of business; and
- at the audit report level, for example, whether the auditor's report should express a clean opinion or not.

1.41 As well, disagreements can exist between colleagues on the audit team, between the audit team and specialists consulted within the Office, and between the audit team and other internal and external advisors.

1.42 The Office has developed an approach that should be followed when resolving and documenting differences of professional opinion. These are:

- differences of opinion within the audit team should be resolved, where appropriate, through discussion led by the audit Principal;
- differences of opinion between the audit team and internal or external specialists should be resolved, where appropriate, through discussions led by the responsible Assistant Auditor General, aided by the reference Assistant Auditor General, where appropriate; and
- differences of opinion that cannot be resolved between the team and specialists are referred to the Deputy/Auditor General, as appropriate.

1.43 In all cases, the audit file should reflect the various professional considerations raised, alternatives considered and the conclusion reached. The documentation should be prepared by a senior member of the audit team and should present the relevant facts in a constructive, comprehensive and authoritative manner that avoids comments of a personal nature.

Sufficient and Appropriate Audit Evidence

1.44 The Strategic Plan is intended to provide a high level roadmap as to the most efficient and effective strategy for obtaining sufficient appropriate audit evidence to support the auditor's report. The detailed audit programs, in turn, provide specific directions to audit staff regarding the nature and extent of audit tests to perform. Therefore, at the completion of the detailed planning and testing phase of the audit, the team should have acquired the requisite evidence.

1.45 However, the plans are only as good as their execution. Proper supervision and coaching will help ensure that the audit objectives have been met and that a quality audit has been achieved. This is confirmed through file review and other corroborative means. The audit Principal and the individual responsible for detailed planning and testing are responsible for providing this assurance.

ANNUAL AUDIT POLICY

The audit Principal and the individual managing the detailed planning and testing should ensure that there is sufficient and appropriate audit evidence to support the content of the Auditor's Report.

1.46 For the annual audit of the Public Accounts of Canada, the Public Accounts team relies on the work performed by the entity teams to ensure that there is sufficient and appropriate audit evidence to support the content of the auditor's report. Entity teams are responsible for ensuring that there is sufficient and appropriate audit evidence to support the content of the Large Entities Audit Report, Small Entities Principal Approval, Micro Entities Principal Approval and Separate Opinion Entities Principal Approval, which are included in the Reporting Package to the Public Accounts team.

Supervision and File Review

1.47 Supervision is an important aspect of quality management. Staff supervision should emphasize "real-time" supervision and coaching that builds in quality as the audit unfolds.

1.48 Although verbal interaction is an important tool for helping to ensure that audits are well conducted, file reviews are also an essential tool for providing quality assurance to the Office and for teaching purposes.

1.49 The quality-related benefits of file review are maximized when the reviewer(s) concentrates on matters of significance, while its teaching benefits are maximized when feedback is timely. In order for both of these benefits to be realized, file reviews should be completed by an appropriately senior member of the audit team. On-site file reviews are encouraged by the Office, because they promote timely discussion between the reviewer and the auditor, eliminate unnecessary queries and facilitate quick responses by the auditor.



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1.50 The nature and extent of file review is a function of audit risk and significance. Each file, however, would normally be reviewed by an individual more senior than the individual who prepared the file, and who possesses appropriate knowledge and experience in the areas subject to review.

ANNUAL AUDIT POLICY

All working papers should be reviewed, on a timely basis, by a qualified member or members of the audit team.

The Audit of the Public Accounts of Canada

1.51 The annual audit of the Public Accounts of Canada is the largest annual audit in Canada. As such, it touches most entity teams in the Office. Therefore, it is important that there is an understanding of how this audit is managed and where general responsibilities lie.

1.52 The Public Accounts annual audit is the examination of the financial statements of the Government of Canada. For this audit, the Office's primary reporting responsibility is to the House of Commons. The objectives of the Public Accounts annual audit are derived from the Auditor General's responsibilities set forth in Section 6 of the *Auditor General Act*:

"the Auditor General shall examine the several financial statements required by section 64 of the *Financial Administration Act* to be included in the Public Accounts, and any other statement that the President of the Treasury Board or the Minister of Finance may present for audit and shall express his opinion as to whether they present fairly information in accordance with stated accounting policies of the federal Government and on a basis consistent with that of the preceding year together with any reservations he may have."

Managing the Audit

1.53 The Principal responsible for the Public Accounts team has been delegated responsibility for the annual audit of the Public Accounts of Canada. The Public Accounts team Principal is responsible for the overall planning, execution and reporting of the audit. For practical reasons, some of these responsibilities are delegated to entity Principals, who are responsible for those aspects of the Public Accounts audit touching the entities (departments, agencies, Crown corporations or other entities) they have day-to-day responsibility for. The entity team Principals provide some of the evidence necessary for the Public Accounts team Principal to complete his/her work and opine on the financial statements of the Government.

1.54 Exact roles and responsibilities are generally outlined in material supplied to the entity teams by the Public Accounts team. The primary sources of this information are the *Central Strategic Plan for the Annual Audit of the Summary Level Financial Statements of the Government of Canada* and the

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annual planning memorandum from the Public Accounts team Principal to entity team Principals. Further information is available from the Public Accounts team Principal.

Methodology

1.55 The methodology outlined in this Manual applies to the annual audit of the Public Accounts of Canada. The Office policies included in this Manual were written from the point of view of managing a single audit engagement of one entity. Clarification on how Office policies apply to the audit of the Public Accounts of Canada has been provided throughout this Manual.

1.56 For the annual audit of the Public Accounts of Canada, if it is considered inappropriate or impractical to comply with Office Policies and Generally Accepted Auditing Standards and/or apply Office methodology, the entity team Principal should obtain the approval of the Public Accounts team Principal. The Public Accounts team Principal should then obtain the approval of the Assistant Auditor General responsible for the audit of the Public Accounts of Canada and the Auditor General and/or Deputy Auditor General. **This should be considered an extension of the annual audit policy described in the *Introduction* section of this Manual.**

Access to Audit Files

1.57 Audit files are the property of the Office and the information they contain is not generally available to others. Audit files may contain sensitive information about the audit entity that needs to remain strictly confidential, for example, information involving solicitor/client privilege, or the entity's evaluation as to the collectibility of specific customer receivables. They also may contain information about our own assessments and evaluations of potentially sensitive accounting and auditing matters that could prove embarrassing if they were read out of context. Additionally, files could contain classified information requiring security clearance levels in excess of those seeking access. For these reasons and others, access to Office files is normally restricted to internal use.

1.58 Access to our audit files to external parties is normally provided only in the following circumstances:

- *when a successor auditor has been appointed, or when a new joint auditor has been appointed.* This is normal professional practice where the interests of the client are best served by full co-operation between predecessor and successor auditors. Before any access is granted, there should be a clear understanding, in writing, of the terms and conditions under which access is granted. Successor auditors would normally be supervised as they conduct their review work on our files;
- *when our audit files have been subpoenaed as evidence in litigation.* Our audit files can and have been used as evidence in cases of litigation. Legal Services would normally be responsible for providing the subpoenaed information as and when required;

- *at the client's request.* Occasionally our clients request access to our audit files. Typically this relates to requests from internal audit or from managers wishing to be provided with our descriptions of their accounting systems. In these situations, the audit Principal should attempt to provide the information required by the client through means other than review of our audit files; and
- *for external inspections conducted by the provincial institutes of chartered accountants.* In these cases, access is coordinated through the Professional Practices and Review Group in Ottawa, and through the regional Principals otherwise.

1.59 The audit Principal is responsible for dealing with the question of access to audit files and for ensuring appropriate security practices are adhered to should access be granted. There should be consultation with the responsible Assistant Auditor General and with Legal Services should circumstances warrant.

ANNUAL AUDIT POLICY

Audit teams should provide access to our working papers to successor auditors when they acknowledge to us, in writing, the terms and conditions under which access is granted.

Guidance and Tools

1.60 The Office methodology as described in this Manual is supported by a number of other sources of additional written guidance, audit software tools, and other materials. This information is all available through the Annual Audit *Quality Management System* Intranet Site. A brief explanation of each of these is provided below:

Additional Written Guidance

Audit Guidance

Audit guidance has been developed to provide direction to staff in selected areas, usually relating to detailed planning and testing. The guidance provided is more detailed than the material provided in this Manual (e.g. application of analytics).

Financial Reporting Guide

This Guide provides auditors with advice on current and emerging accounting and reporting issues pertinent to the entities we are responsible for auditing.

Predetermined Audit Documentation (PADs)	These documents and forms assist the auditor in completing all phases of the annual audit. PADs include material such as standard forms, indexes and checklists, guidance and standard “boiler plate” material for reports such as those to audit committees.
Public Accounts (Section 6) Area in the QMS Annual Audit Practice Intranet Site	This database provides access to all guidance, tools and other specialized material applicable to the annual audit of the Public Accounts of Canada.

Audit Software Tools

1.61 A number of software tools are available to assist auditors, including the following:

APEX	APEX is used in the strategic planning and detailed planning phases of the audits. The software facilitates documentation of the planning process, and assists the auditor in assessing whether audit programs provide adequate evidence to support component assertions and address identified risk factors.
PW Controls	PW Controls assists the auditor in placing reliance on processing controls. Auditors are provided with a listing of potential control procedures and a means of documenting the results of their work.
IDEA	IDEA assists auditors in extracting and analyzing data from client files, as well as in the planning, extraction and evaluation of statistical samples.
ATTEST	ATTEST is used by entity teams involved in the annual audit of the Public Accounts of Canada to report audited balances, errors and summary information about letters of representation. The Public Accounts team uses ATTEST to accumulate the information reported by entity teams and to re-perform the consolidation of the Summary Financial Statements and the notes.

Other Materials

1.62 Other more general guidance materials are available from the Library, while specialized guidance may be obtained through Office specialists (see the *Consultation* section of this Manual).

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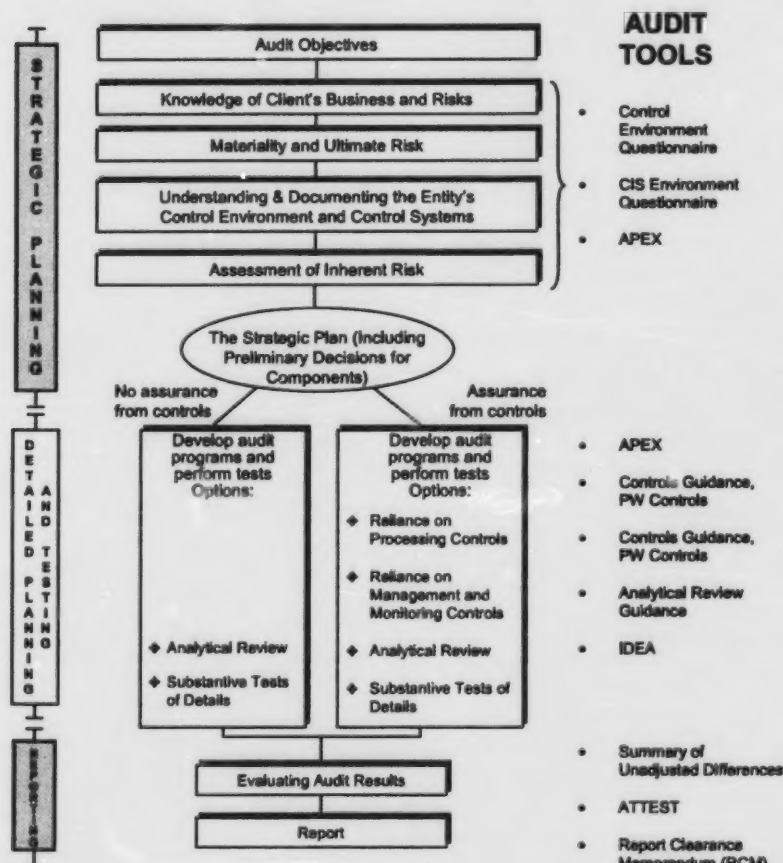
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2

Approach to Annual Audits

Conceptual Overview for Conducting the Audit

2.1 The following represents a pictorial overview of the Office's approach to conducting annual audits. More extensive discussion of each major component of the annual audit begins with *Strategic Planning*, following the *Risk and Audit Assurance* section of this Manual.



Risk and Audit Assurance

Relationship of Our Methodology to the Ultimate Risk Model

2.2 The Office's approach to annual audits continues to be based on the Ultimate Risk Model:

$\text{Ultimate Risk} = \text{Inherent Risk} \times \text{Control Risk} \times \text{Substantive Risk}$

2.3 The objective for the auditor is to first assess inherent and control risks in the entity, and then to design and perform appropriate compliance and substantive procedures that provide sufficient assurance such that the product of the risks identified above is less than or equal to the 5 percent ultimate risk the Office is willing to assume (note that risk = 1 - assurance).

2.4 The Office's annual audit approach is structured to achieve this objective by maximizing, to the extent prudent and practical, inherent assurance and control assurance. Of course, some substantive assurance must always be obtained by auditors. However, the methodology encourages the auditor to obtain this substantive assurance primarily through analytical procedures, and only if necessary from substantive tests of details.

2.5 While the methodology is based on the Ultimate Risk Model (URM), the formula itself will only rarely be used by the auditor in the mathematical sense. APEX, the Office's software planning tool, helps to determine for the auditor the degree of audit assurance derived from performing specific audit procedures. The URM provides information primarily related to the extent of audit testing, whereas APEX also takes into account the nature and timing of audit procedures in determining the degree of audit assurance derived. This provides a more comprehensive indicator of assurance than the URM alone.

Inherent Assurance

2.6 Our methodology maximizes inherent assurance by requiring a rigorous and thorough assessment of risk on a component-by-component, assertion-by-assertion basis. These assessments are the responsibility of the audit Principal assisted by the Director, the most knowledgeable and experienced individuals on the audit team. Those individuals are expected to maintain a comprehensive, up-to-date knowledge of the entity's business environment and associated risks. This requires that they be familiar with the entity's strategic plans, developments in the industry sector in which it operates, government expectations and policies that influence the entity's plans, and developments in the accounting and auditing profession that may affect the entity's financial statements or its corporate accounting and management information systems.

2.7 The importance of the inherent risk assessments cannot be over-emphasized. They not only provide a source of inherent audit assurance, they also drive the extent of audit testing. That is, the greater the inherent risk, the greater the audit effort required. Since overall audit efficiency is influenced by the inherent risk assessments, choosing an appropriate starting position for the assessment is important. Where the team has one or more years of experience with an entity and there is no history of material errors in a particular component,

beginning the inherent risk assessment process from the perspective that risk is low is appropriate. This will help to ensure that low risk areas are not over-audited. For new clients, significant new financial statement components, new or amended legislation or new programs introduced by the entity, beginning from a moderate inherent risk perspective may be more appropriate. Given the implications of an inappropriate inherent risk assessment, the audit Principal must be involved in making these risk assessments.

Control Assurance

2.8 Our methodology also encourages a controls-reliant approach to conducting the audit, which generally provides a significant degree of assurance more efficiently than through substantive audit techniques. Obtaining this assurance requires not only that effective controls exist at the component level, but also that the overall control environment and control systems of the entity are conducive to such an approach. Consequently, the audit team must perform a comprehensive review of the overall control environment, assessing such factors as management philosophy and operating style, corporate governance practices and the computerized information systems (CIS) environment.

2.9 In most cases, this review is expected to conclude that a controls-reliant audit approach is warranted and control assurance will be obtained principally through testing of processing controls and management and monitoring controls. Processing controls are designed to prevent any errors in individual transactions from being passed on to a subsequent processing phase. Management and monitoring controls are generally analytical procedures that are performed by management of the entity on a regular basis and that provide assurance as to the completeness and accuracy of processing of a class of transactions or compliance with legislative and/or other authorities. Again, the knowledge and experience of the audit Principal and the Director is applied in assessing the overall control environment and control systems in order to determine whether or not a controls-reliant approach is warranted for specific components and assertions.

2.10 While the Office encourages adoption of a controls-reliant approach, it is recognized that for some audit entities, particularly our smaller clients and the Public Accounts of Canada, a substantive approach may be more appropriate and more cost-effective. In such cases, audit assurance would be derived from a combination of analytical procedures and substantive tests of detail.

Substantive Assurance

2.11 Because of the inherent limitations of internal control in any organization, the auditor always seeks some corroborative substantive assurance. The Office's methodology encourages auditors to obtain this assurance primarily through the use of analytical procedures. These are generally more efficient than substantive tests of detail because they typically address more than one assertion. Under the Office's approach, assurance is only sought from substantive tests of detail when sufficient, appropriate audit evidence cannot be derived in a cost-effective manner from some combination of reliance on processing controls, management and monitoring controls and/or analytical procedures.

3

Strategic Planning

Audit Objectives — Terms of Engagement

General

3.1 The annual audits we conduct of the Public Accounts of Canada, the Territories, Crown corporations and other entities are designed to provide our opinion to readers on the fair presentation of the financial statements. Further, as Parliament's auditor, we have additional responsibilities conferred on us with respect to reporting on compliance with legislative authorities, and a general duty to also report on any "other matters" that, in our opinion, should be brought to the reader's attention. These duties extend beyond the traditional attest audit mandate of our private sector colleagues. Accordingly, they must be explicitly taken into account in the planning, execution and reporting phases of the audit.

Basis of Presentation of Financial Statements and Consistency of the Application of Accounting Principles

3.2 Normally, the basis for preparation of financial statements and our report thereon is established in legislation. For federal Crown corporations, Section 132 (2) of the federal *Financial Administration Act* requires the auditor to report on whether the financial statements are presented fairly in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

3.3 The *Auditor General Act* requires the Auditor General to express an opinion on whether the Summary Financial Statements of Canada are in accordance with the stated accounting policies of the federal government applied on a basis consistent with that of the preceding year. For this audit, we separately opine on the fair presentation of the financial statements.

3.4 Generally Accepted Accounting Principles require entities to provide disclosure of changes in the application of accounting principles. If an entity has complied with this GAAP requirement, then Generally Accepted Auditing Standards would not require the auditor to report on this matter. Accordingly, in establishing the terms of engagement for a specific entity, we would not include a requirement to report on the consistent application of accounting principles unless it is required by legislation.

Compliance with Authorities — Crown Corporations and Other Entities

3.5 Parliament, under the limits set out in the Constitution, has the pre-eminent position in the Canadian system of government because it makes the laws by which we are governed. The Cabinet, whose authority to govern derives from the constitution, is subordinate to Parliament because it is constrained by laws passed by Parliament. The appropriate ministers responsible for Crown corporations report to Parliament in discharging their accountability for these corporations.

3.6 To operate effectively, a system of government must itself demonstrate a high degree of respect for and compliance with the law. This extends to all authority instruments by which Parliament and the government of the day convey the intention of how the authority is meant to work. Examples of these instruments include the *Financial Administration Acts (FAA)* of the federal and territorial governments, regulations, and charters and by-laws of Crown corporations. The responsibility for observing the provisions of the applicable authorities governing the entity rests with its management. They are expected to develop management controls designed to provide reasonable assurance of compliance with legislative authorities.

3.7 The role of the Office as legislative auditor of Crown corporations and other entities is governed by the federal and territorial governments' *FAA* and by the *Auditor General Act*. The Office may also be asked to provide an opinion on compliance by virtue of an order in Council pursuant to Section 11 of the *Auditor General Act*.

3.8 For scheduled Crown corporations, subsection 132(2) of the federal *FAA* requires the auditor to provide an opinion as to whether the transactions of the corporation and of each subsidiary that have come to the auditor's notice in the course of the examination were in accordance with Part X of the *FAA*, the regulations, the charter and by-laws of the corporation. The audit responsibility is primarily to ascertain and report on whether the stated authorities have been complied with in all significant respects. The opinion is to be included in the annual auditor's report to the minister responsible for the corporation.

3.9 Compliance with authorities is not limited to the financial transactions in the narrow sense, but rather covers any activity for which the entity is responsible, such as the preparation of the corporate plan. In addition to this, the auditor's understanding of the entity's business and legal framework may cause him or her to become aware of situations or transactions that could infringe Canadian legislation. It is important for the auditor to assess such transactions for their possible impact on financial statements and to consider them for reporting to the appropriate authority.

3.10 The *Auditor General Act* requires the Auditor General to report any matters that he considers to be of significance or of a nature that should be brought to the attention of the House of Commons. Regardless of whether the specific annual audit mandate requires compliance reporting we would report non-compliance uncovered and considered as important for Parliament. In the case of Crown corporations, instances of non-compliance that are considered

significant must be reported to the appropriate minister in accordance with the relevant subsections of the *FAA*. Once reported, they become candidates for inclusion in an Auditor General's periodic Report, generally as an Audit Note. Reporting in a periodic Report would normally only be made after the corporation's annual report is tabled in Parliament.

"Other Matters" — Crown Corporations and Other Entities

3.11 For scheduled Crown corporations, subsection 132(2) of the federal *FAA* requires the auditor to call attention to any significant "other matter" falling within the scope of his or her examination that, in his or her opinion, should be brought to the attention of Parliament. Similarly, the *Auditor General Act* requires the Auditor General to report any matters that he considers to be of significance or of a nature that should be brought to the attention of the House of Commons.

Compliance with Authorities — Public Accounts of Canada

3.12 A fundamental principle of control over the public purse is that Parliament's authorization is required for the government to spend, borrow and raise revenues.

3.13 Spending authority is granted through the appropriation legislation. Government programs and activities are first given legal effect through enabling or "program" legislation. Appropriation authority may be contained in such legislation when it specifies the conditions under which payments may be made or it specifies the amounts to be paid, until the authority is withdrawn (statutory authorities). Annual spending is authorized by appropriation acts. The schedules to appropriation acts are made up of "votes", which set the limits and stated purpose for which the government may spend money.

3.14 Borrowing is normally authorized through the borrowing acts. Borrowing may also be authorized under Section 47 of the *Financial Administration Act (FAA)*.

3.15 The raising of revenue is authorized through specific legislation such as the *Income Tax Act*. Subject to the provision of such legislation, revenues may also be authorized through general legislation such as Section 19 of the *FAA*, which provides for the Governor in Council to set fees or to authorize ministers to set fees by order.

3.16 Compliance with authority to spend, borrow, and raise revenues is a basic principle underlying the government's accounting system. The accounts of Canada generally reflect parliamentary authorizations by including an authority code within the chart of accounts coding block for each vote or continuing statutory authority, each type of borrowing and each type of revenue. The Public Accounts of Canada, which are prepared from the accounts of Canada, report on the government's use of each of these authorities.

3.17 The Summary Financial Statements of Canada are included in the Public Accounts. As an overall summary, their fundamental purpose is "to provide

information to Parliament, and thus to the public, to facilitate an understanding and evaluation of the full nature and extent of the financial affairs and resources for which the Government is responsible". The notes to the Summary Financial Statements also include summaries of compliance with spending and borrowing limits. In addition, general statements of compliance are contained in the Preface to the Financial Statements of the Government of Canada and the Statement of Responsibility by the government.

3.18 Unlike the auditor's requirements for Crown corporations, there are no specific requirements under the *FAA* or the *Auditor General Act*, to include any statement in the Auditor General's opinion on the Summary Financial Statements on compliance with authorities. Nevertheless, given the fact that the Auditor General's opinion on the statements extends to the appended notes, given the role of the Office as legislative auditor, and given the representations of management in the statements related to compliance, the authorities component is an integral part of the audit of the Summary Financial Statements of Canada. Accordingly, the audit should reflect compliance with spending, borrowing and revenue authority considerations.

Terms of Engagement — All Entities

3.19 In all of our engagements, the Office and the audit entity should share a common understanding of the terms of the engagement — both our statutory audit work and any other work that may be performed.

3.20 Many of our audit engagements are statutory and of a long-standing nature. Even though we may believe that our audit entities have a clear understanding of the nature of our audit work, it is still important to set out in a clear and unambiguous manner the significant aspects of our terms of engagement. Communicating this information to senior management and the Audit Committee (or its equivalent) helps each of them discharge their responsibilities and confirms their understanding of what an audit does and does not do.

3.21 Communication of this information is normally accomplished through a report to the Audit Committee, or through a formal engagement letter.

ANNUAL AUDIT POLICY

Audit teams should ensure that the terms of reference for the audit engagement, significant features of the audit scope and responsibilities assumed are clearly set out in a formal written communication with the audit entity (e.g. Report to the Audit Committee and/or engagement letter).

3.22 For the annual audit of the Public Accounts of Canada, the Public Accounts team is responsible for establishing and communicating the terms of the engagement with the Government of Canada, specifically the Treasury Board, Finance and Receiver General who are jointly responsible for preparing the financial statements. Entity teams are not required to set out the terms of

engagement in a formal written communication with the department, agency, Crown corporation or departmental corporation that they are responsible for auditing.

New Engagements

3.23 Occasionally, we may be asked by the audit entity or by the Governor in Council to perform non-statutory audit work. Examples of this have included, for example, work on prospectuses and providing assistance in determining a fair division of assets between the Northwest Territories and the Nunavut Territory. In addition, new legislation may create corporate bodies for which we become the appointed auditor, for instance the recently created Canadian Food Inspection Agency. In such cases, it is important to ensure that the terms of engagement are appropriate for the circumstances and, to the extent appropriate, consistent with that of similar work in other entities we audit. As well, there may be developments in the profession that need to be taken into account in establishing appropriate terms of engagement. Accordingly, there should be consultation with Legal Services (refer to *Practice Expectations Common to all Product Lines*) and the Annual Audit Practice team.

ANNUAL AUDIT POLICY

The audit team should consult with the Annual Audit Practice team on the terms of engagement of new or proposed annual audit engagements.

Knowledge of the Entity's Business and Risks

General

3.24 The Office's methodology seeks to obtain as much inherent assurance as is prudent and practical. In order to do so, the Office relies on the audit Principal, and to a lesser extent the Director, to maintain a high degree of knowledge about the entity and the business environment it operates in. This knowledge is applied on a component-by-component, assertion-by-assertion basis, to identify the areas of risk to the audit and to direct the audit effort accordingly.

3.25 There are six critical knowledge areas:

- i) the entity's business and its strategic plans;
- ii) the legislative authorities affecting the entity's operations;
- iii) the industry in which it operates, including competitive strategies, specialized accounting practices and performance indicators;
- iv) economic trends that can affect the valuation of significant assets and liabilities (e.g. exchange rates, changes in demand);
- v) the government's expectations and priorities; and
- vi) developments in the accounting and auditing profession that affect the entity and/or the industry.

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ANNUAL AUDIT POLICY

Audit teams should have sufficient understanding of their audit entity's business and the industry(ies) in which it operates to identify and evaluate audit risks and to design an effective and efficient approach to the audit.

3.26 A thorough knowledge of the entity's business is important for more than just assessing inherent risk. It also provides a sound basis for:

- determining materiality levels;
- identifying the significant authority requirements impacting the entity's operations and the entity's approaches to ensuring compliance with them;
- understanding the substance of transactions and the inter-relationship between components;
- designing audit procedures pertaining to components highly influenced by management judgements and estimates;
- assessing the appropriateness of management's selection and application of accounting principles; and
- evaluating the overall financial statement presentation and the reasonableness of the overall results.

3.27 The list above illustrates that knowledge of the entity's business is important to all phases of the annual audit. Accordingly, obtaining and applying this knowledge is a continuous and cumulative activity that should be performed throughout the audit.

3.28 Ways in which the requisite knowledge can be obtained are described in the sections that follow. In assessing the sufficiency of knowledge obtained about a specific aspect of the audit entity's business, the auditor should consider the knowledge acquired in relation to its expected significance to the audit.

Compliance with Authorities and "Other Matters"

ANNUAL AUDIT POLICY

Audit teams should have sufficient understanding of authority instruments subject to audit and potential "other matters" to evaluate audit risks and to design an effective and efficient approach to the audit.

Crown Corporations and Other Entities

3.29 Regardless of the type of auditing for compliance with authority, it is critical that the auditor fully understand the authority framework governing the entity, the audit mandate, and the transactions subject to audit. Otherwise, there is a risk that the audit procedures will not be tailored to the specific needs of auditing compliance with authority or will be inappropriately executed.

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3.30 The Office has interpreted its responsibility for reporting on compliance with authorities to be a separate opinion on compliance with specified authorities, as opposed to a derivative one. Accordingly, readers of our reports are looking for assurance that significant transactions (or events) that would reasonably be expected to come to our notice during the conduct of the annual audit have been assessed for compliance with governing authorities and that we have reported on all significant cases of non-compliance.

3.31 Some legislative requirements of the *Financial Administration Act* and other authorities are not necessarily related to individual financial statement components. For example, the provisions relating to the need to have corporate plans and budgets, internal audit function, and so on, do not directly affect the financial statements. Specific audit procedures may need to be applied as part of auditing these elements of compliance with authority.

3.32 In developing the strategic direction, an assessment should be made of the risk of significant non-compliance with the identified governing authorities. A number of factors need to be considered when making this assessment including knowledge of the entity, past audit experience, and management's attitude towards compliance. It is important to involve senior members of the audit team in making these judgements.

3.33 An important part of knowledge of the business is also the identification of possible "other matters" that should be brought to the attention of Parliament. Similar to the above, we would rely on the judgement of senior members of the audit team (Principal and Director) and their past experience with the client and knowledge of current and emerging issues affecting the entity.

3.34 During the strategic planning stage, the audit Principal should ensure that:

- the relevant authority requirements have been identified (e.g. the *FAA* and regulations, enabling legislation, appropriation acts, by-laws of Crown corporations and any directives issued under section 89 of the *FAA*, etc.);
- the authority requirements have been reviewed and significant and/or high-risk ones identified;
- potential "other matters" have been identified; and
- the audit approach, including any specific procedures considered necessary for providing sufficient, appropriate audit evidence in relation to these authorities and "other matters" have been adequately documented.

3.35 Specific guidance on significant requirements of the *FAA* and regulations and the *Canada Business Corporations Act* are contained in the PAD Authority guidance tool. **Significant requirements of entity-specific authority instruments should be identified, and the risk of non-compliance assessed, by the audit team.**

3.36 The auditor has to keep in mind the compliance with authority and “other matters” aspects of the audit throughout strategic planning, detailed planning and testing and reporting phases of the audit. Accordingly, the auditor would consider the implications on compliance auditing in doing such things as gathering information on client accounting and information systems, assessing the control environment, developing detailed audit programs and assessing audit results. To the extent practicable, procedures for assessing compliance with authorities should be integrated with the regular annual financial audit work.

Public Accounts of Canada

3.37 In developing their strategic plans for the audit, entity audit teams should identify and understand the appropriation, borrowing and revenue authorities granted to their entities or activities comprising the Summary Financial Statements, to be able to identify instances of significant non-compliance with authorities. Entity audit teams need to have a general understanding of the significant authorities governing the establishment and operations of the entity, but it is critical that the audit team fully understand the appropriation, borrowing and revenue authorities subject to audit.

3.38 The inherent risk and significance of non-compliance with appropriation, borrowing and revenue authorities should also be assessed in setting specific audit objectives. In planning the authorities component of the audit, audit teams should focus on areas where there is a significantly high risk of non-compliance with authority. Entity teams should make a separate assessment of the inherent risk regarding the likelihood that an expenditure has been made, or revenue collected, or money borrowed that is, in all material respects, not in accordance with the limits and/or purpose set out in the appropriation, borrowing or revenue authorities. The scope to be used to make this assessment is established annually by the Public Accounts team.

3.39 An authority component should be included in any spending, borrowing or revenue transaction selected for substantive verification. The objective of this work will be to form a judgement as to whether the transaction met the intended purpose of the underlying authority. Where there is reliance on internal financial controls for purposes of the audit, compliance-with-authority components should be included in tests of internal control systems.

3.40 Given the stated purpose of the Summary Financial Statements, auditors should focus on compliance with appropriation, borrowing and revenue authorities. The Office generally takes a cyclical approach to auditing other authorities. However, in order to provide additional information on compliance with authorities, all authority work conducted by the Office during the year and issues observed will be summarized and considered before the Auditor General's opinion is finalized.

Meeting with Entity Senior Management

3.41 The audit Principal and the Assistant Auditor General (AAG) should attempt to meet with the President (or Chief Operating Officer or Senior Financial Officer, as appropriate) of the audit entity during the strategic planning

process. This provides the audit Principal and the AAG with an opportunity to understand and appreciate the views of the individual responsible for managing the business affairs of the entity. Of particular significance are his/her views on the major risks to achievement of the entity's corporate objectives, how these risks are managed, and the state of the current business environment. The meeting also provides a useful forum to:

- discuss the likely matters of audit significance, especially management judgements and estimates that are significant to the financial statements;
- identify recent plans, events or proposed legislation that may have an impact on the audit;
- determine whether there have been any recent internal audits on which reliance might be practical; and
- identify any areas to which management would like the auditor to pay particular attention.

Reviewing the Annual Business Plan

3.42 Most entities are required to prepare and document annual business plans. Such documents are normally referred to as Budgets, Estimates Part III (Plans and Priorities), Departmental Performance Reports, Corporate Plans, Departmental Business Plans and other strategic planning documentation.

3.43 The annual Business Plan typically provides information relevant to the critical knowledge areas referred to in the *General* section of *Knowledge of the Entity's Business and Risks*. These plans, or some variant, are prepared annually by departments, agencies, Crown corporations and most other entities for which the Office conducts annual audits. The Plan will normally describe the entity's assessment of the risks and opportunities of its business environment, as well as its strategies for dealing with them and achieving its statutory goals and objectives. For most entities, a review of its annual Business Plan should be considered an essential pre-requisite to developing the Strategic Plan for the audit.

3.44 When reviewing the full Corporate Plan of Crown corporations, it is important to note that Office security practices require this be done on Corporate premises, and that normally the auditor would not retain a copy of the full Plan, even if it is appropriately secured. The Summary Corporate Plan, which is tabled in Parliament, should be included in the Planning and Control File so that audit staff can refer to it as needed. (note: Security issues are discussed in more detail in the *Practice Expectations Common to all Product Lines* section of this Manual)

Analysis of Interim Financial and Other Information

3.45 Analysis of interim financial results gives the audit Principal a perspective on the extent to which plans are being achieved, whether explanations from management are plausible, the impact and significance of potential new developments, and whether results are consistent with the auditor's expectations based on current and previously acquired knowledge.

3.46 “Other information” that contributes to a more comprehensive understanding of the entity’s business and risks includes:

- minutes of senior management committee meetings, such as those of Departmental Management Committees, the Board of Directors and Audit Committee meetings;
- analysis of corporate performance reports including management variance analyses, year to date cash flow reports, key financial ratios, etc;
- analyses of changes in the economic situation of the entity’s customers or stakeholders;
- analyses of changes in the entity’s major competitors and/or its key suppliers;
- significant economic developments affecting (or potentially affecting) clients and or stakeholders of the entity;
- Parliamentary interest in the entity’s operations;
- results of the recently completed and relevant VFM (Value for Money) audits, Special Examination reports and Audit Notes;
- internal audit reports that have been issued in the year; and
- newspaper or magazine articles related to the entity or its business.

3.47 Where these reviews reveal a significant change, unusual relationship or unexpected outcome not consistent with the audit Principal’s expectations, additional work should be undertaken to assess any possible impact on the development of the Strategic Plan.

Identifying New and/or Emerging Accounting or Auditing Issues

3.48 The audit Principal should ensure that the audit team has identified any new or emerging accounting or auditing issues that may impact the audit. These issues may result from developments such as new business activities, restructuring efforts, new accounting pronouncements coming into effect for the first time, changes in generally accepted accounting principles for a particular industry or for government operations, or exposure drafts that could affect the way in which the entity accounts for its assets, its liabilities or its business activities.

3.49 The impact of any such developments should be reflected in the Strategic Plan and also, to the extent considered necessary, in the detailed audit plans. Changes and/or new developments that may significantly affect the financial statements should normally be discussed with the senior management of the entity and with the Audit Committee or other appropriate body, such as the Comptroller General, the Receiver General or the Department of Finance.

3.50 We also need to be aware of any plans by the entity to make any significant changes in accounting policies, as this may have an impact not only on the financial statements but also on our auditor’s report for those audit entities where we are required to opine on consistency. For example, this would apply to

Crown corporations governed by Part X of the *Financial Administration Act* and the Public Accounts of Canada.

Client Accounting and Information Systems

3.51 It is also important during the strategic planning phase to ensure that audit staff have accumulated an up-to-date knowledge of each accounting and internal control system of audit significance, including an understanding of:

- the impact of the entity's business processes and how they have influenced the design of management and accounting business systems;
- the types of transactions and documents processed by the systems;
- the manner in which the transactions are initiated and processed; and
- how transactions and balances are assembled and summarized for financial reporting purposes.

3.52 Note that GAAS (Generally Accepted Auditing Standards) require the auditor to obtain an understanding of the control environment and the control systems that collect, record and process data and report the resulting information, even when no reliance is to be placed on controls. The levels of understanding required by GAAS are illustrated in the following table.

GAAS Requirements for Understanding Internal Control

Knowledge Area	Substantive Approach	Controls - Reliant Approach
Control environment	✓	✓
Control systems that collect, record and process data and report the resulting information	✓	✓
Control systems that enhance the reliability of data and information		✓

Consultation with Specialists

3.53 An important element of acquiring an appropriate "knowledge of the business" is identifying matters of potential audit significance that require expertise outside of the core audit team. The following is a list of individuals/teams within the Office with whom consultation is either required or expected:

- Reference Assistant Auditors General;
- the Annual Audit Practice team (required for the audits of Crown corporations and other entities);
- the Information Technology team;

- the Financial Instruments team; and
- Legal Services.

3.54 Consultation methodology and policies are discussed in more detail in the *Consultation* section of this Manual.

Materiality and Ultimate Risk

3.55 Materiality. In performing an audit, we seek reasonable assurance that the financial statements as a whole are not materially misstated. In the "Introduction to Accounting Recommendations" in the CICA Handbook, materiality is defined as follows:

"While materiality is a matter of professional judgment in the particular circumstances, the Board believes that as a general rule, materiality should be judged in relation to the significance of financial statement information to decision makers. An item of information, or an aggregate of items, should be deemed to be material if it is probable that its omission or misstatement would influence or change a decision."

3.56 Although this definition does not tell the auditor how to determine materiality, it does indicate that:

- materiality should be determined from the user's point of view and not from management's or the auditor's; and
- materiality should be determined without reference to ultimate audit risk. That is, materiality should not be reduced on high-risk audits or increased on low-risk audits.

3.57 Guidelines for determining materiality. Materiality is always relative and always requires judgement; therefore it is usually not possible to lay down specific rules or absolute numerical measurements that will be valid in every case. Consequently, the materiality decision ultimately becomes a matter for the auditor's professional judgement. "Planning" materiality should normally be set more conservatively than what would be considered materiality for reporting purposes.

3.58 The CICA has developed some guidelines that may be useful to the audit Principal. These are found in the assurance and related services guideline AuG-7 "Applying Materiality and Risk Concepts in Conducting an Audit" (March 1990).

3.59 Ultimate Risk. The ultimate risk is the inverse of overall audit assurance. It is the risk that, after completing the audit, misstatements aggregating to more than materiality will remain undetected in the financial statements.

3.60 The Office has taken the position that an appropriate level of ultimate risk is 5 percent for most of our audit entities. An assumption that the ultimate

risk for a particular engagement is something other than 5 percent should be explained in the Strategic Plan.

3.61 Compliance with Authorities. When auditing compliance with authorities, the auditor is concerned about *significance* as opposed to materiality. Although the two are conceptually similar, they are not used interchangeably. However, like materiality, significance is always relative and always requires professional judgement.

3.62 A legislative authority is significant if a reader would expect the auditor to bring to his/her attention in the auditor's report any instance(s) of non-compliance with it. Not all legislative authorities are significant, and like materiality, the auditor has the responsibility of determining what is significant, keeping in mind the interests and expectations of the user.

3.63 Just as any material amount in the financial statements would be subject to audit testing, every significant authority would be tested for compliance during the course of the annual audit. The nature and extent of audit testing is based on our assessment of its significance and our assessments of the risk of non-compliance.

Understanding the Entity's Control Environment and Control Systems

3.64 In order to comply with generally accepted auditing standards, the auditor is required to have an appropriate understanding of the entity's overall control environment and its control systems. This understanding is critical to making informed judgements about the inherent risk of material misstatement in the financial statements and to knowing whether the entity's control environment and control systems are conducive to a controls-reliant audit approach.

"General" Control Environment

3.65 It is important on all of our audits to complete an assessment of the "general" control environment in the entity. This should be done prior to developing the Strategic Plan, since its results are necessary to determine whether an audit strategy emphasizing reliance on controls is appropriate. The audit Principal should take a comprehensive, entity-wide perspective of the client's "general" controls. This broad perspective is necessary because controls, even if well designed, may not be used if the prevailing attitude is that they are unimportant, and appropriate requirements to monitor and periodically review their use are not in place.

3.66 There are eight principal areas of control that should be considered:

- i) management philosophy and operating style;
- ii) corporate governance (Board of Directors, Audit Committee);
- iii) organizational structure;
- iv) management's reaction to external influences;
- v) management control methods;

- vi) responsibilities and authority;
- vii) internal audit; and
- viii) personnel policies and procedures.

3.67 The Control Environment Questionnaire is intended to provide a high level assessment of the audit entity's overall control environment. The nature of information required to complete this questionnaire, though not highly detailed, requires the broad perspectives and insights of senior entity people. Accordingly, it should be completed on the basis of interviews and other knowledge gleaned from experienced and relatively senior officials of the entity.

3.68 Consultation with specialists may be appropriate in assessing the entity's "general" control environment, particularly with respect to clients who are involved with financial instruments (swaps, foreign exchange transactions, derivatives, significant borrowing/lending activities). There have been a number of recent, well-documented cases of control failure in private sector institutions, attributable in large part to inadequate oversight controls. The Office's Financial Instruments team has the necessary expertise to provide advice with respect to the high level controls that should be in place governing the use of financial instruments, and the appropriateness of the information provided to senior management and the Board/Executive Committee.

3.69 For the annual audit of the Public Accounts of Canada, the documentation of the entity team's understanding of the control environment is only required to be performed as outlined in the *Appendix to the Preface to Section 6 Audit Programs on Understanding Internal Control for the Section 6 Audit*. For large entities, this work is to be performed every year. For small and micro entities, this understanding is only required to be documented on a rotational basis. For separate opinion entities, this understanding is expected to be obtained as part of the separate opinion audit.

Assessment of the Entity's Computerized Information Systems (CIS) Environment

3.70 The controls in the audit entity's computerized information systems (CIS) environment are an important part of the "general" control environment. The integration of CIS and applications into most of the business activities of our entities is significant, and will become more so with the growth of EDI (Electronic Data Interchange), EFT (Electronic Funds Transfer), the use of the Internet and other interactive technologies. It is not appropriate to "audit around the computer" and/or assume that the general controls over the entity's CIS operations are sound.

3.71 The audit Principal should ensure that the audit team obtains information about the entity's CIS controls for the purpose of assessing inherent risks of a material misstatement in the financial statements, and to assesses whether or not the CIS controls provide a suitable foundation for reliance on processing and/or management and monitoring controls.

3.72 The CIS Control Environment Questionnaire is intended to assist the audit team in gathering this information and in making these judgements. Some

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entities operate more than one control environment and, in these situations, one CIS Control Environment Questionnaire is required per environment.

3.73 CIS controls may be broken down into the following seven categories:

The 7 CIS Controls

Access
Input
Rejection
Processing

Organization
Program Changes
Access

Application-Specific Controls:

- i) **access** to transaction processing functions of application programs or resultant data records is restricted;
- ii) data entered for processing is **input** accurately, completely and only once;
- iii) **rejected** data and suspense items are isolated, analyzed and corrected on a timely basis;
- iv) **processing** and recording of transactions is accurate, complete and recorded in the proper period;

Environmental Controls:

- v) the structure of the **organization** and the operating procedures of the CIS department are appropriately segregated and provide an environment that is conducive to the preparation of reliable financial information;
- vi) **program changes** to application software are authorized and accurate; and
- vii) general **access** to data or application programs is restricted.

3.74 For the annual audit of the Public Accounts of Canada, the documentation of the entity team's understanding of the CIS environment is only required to be performed as outlined in the *Appendix to the Preface to Section 6 Audit Programs on Understanding Internal Control for the Section 6 Audit*. Not all entity teams are required to complete a CIS Questionnaire.

Use of Information Technology (IT) Audit Specialists

3.75 The involvement of IT specialists in developing an understanding of the audit entity's CIS control environment and control systems is a matter of judgement (refer to consultation methodology and policies in the *Consultation* section of this Manual). Consideration should be given to involving the Information Technology (IT) team, in either doing the work or in reviewing it, in the following situations:

- complex CIS systems or environments;
- planned high reliance on CIS internal audit work;
- significant loss of paper audit trail;

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- complex CIS systems or environments;
- planned high reliance on CIS internal audit work;
- significant loss of paper audit trail;

- introduction of major new financial accounting and/or management systems;
- conversion of historical and/or current year's data to a new format; and/or
- high client expectations.

3.76 It may also be appropriate to involve the IT team where the audit team suspects there are control weaknesses in the entity that could affect the audit approach or the information in the financial statements. The decision as to whether IT expertise is required should be made by the audit Principal in consultation with the Director.

Assessment of Inherent Risk

Inherent Risk — General Considerations

3.77 Inherent risk is the susceptibility of a given financial statement component to error that could be material, when aggregated with error(s) in other components, given the preventive internal controls in place. Put more simply, inherent risk is the chance of a material error occurring in the first place. Under the Office's methodology, assessment of inherent risk is important for two reasons:

- i) as a source of inherent audit assurance; and
- ii) as a driving factor behind the extent of audit testing decision(s).

3.78 Many factors affect the susceptibility of a component to error, and a considerable degree of experience and professional judgement are required to arrive at well-founded inherent risk assessments. This is also why it is so important to have a comprehensive knowledge of the client's business and related risks. Accordingly, the Office expects these assessments to be made by the audit Principal, assisted by the Director.

3.79 For the annual audit of the Public Accounts of Canada, the responsibility for determining the audit strategy is shared between the Public Accounts team and entity teams. For the common financial statement components that apply to most large, small and micro entities, the Public Accounts team is responsible for developing the audit strategy, which includes assessing inherent risk by assertion. The Public Accounts team is also responsible for determining the audit strategy for separate opinion entities. For the financial statement components that only certain large entities have, the responsibility for the development of the audit strategy rests with the large entity team. The responsibility for each financial statement component is documented in an annual planning memorandum from the Public Accounts team Principal to entity team Principals.

Inherent Risk Assessment — Specific Details

3.80 After identifying the general risk factors relevant to the audit, specific inherent risk assessments are made at the component level on an assertion-by-assertion basis. Inherent risk can be assessed at one of four possible levels:

Assessment	Inherent Risk	Inherent Assurance	Target Score
Insignificant	5%	95%	N/A
Low	15%	85%	10 points
Moderate	30%	70%	17 points
High	60%	40%	24 points

3.81 Depending on the risk assessment made, a greater or lesser extent of audit effort is required. The planning software used by the Office, APEX, assigns a specific target “score” to each of the possible levels of inherent risk, which serves as a proxy for the nature and extent of audit testing required.

3.82 In order to develop an efficient and effective audit strategy, the auditor should give appropriate recognition to prior years’ audit results and our experience with the entity. In components with no history of significant or material errors, beginning the inherent risk assessment process from the perspective that risk is low would be appropriate. Any general or component-specific risk factors would then be considered before making a final assessment. Audit Principals and Directors should draw on their cumulative audit knowledge and experience to identify only those risk factors that do apply and have the potential to materially affect the financial statements. Assuming that an appropriate understanding of the business has been acquired, the audit Principal and the Director should not concern themselves with those risks that may apply. This will help to ensure low-risk areas are not over-audited.

Consultation with Specialists

3.83 Assessing inherent risk in specialized areas may be difficult, such as with financial statement components wholly or substantially composed of transactions involving financial instruments, or those heavily dependent on computer-generated transactions. In these situations, it may be appropriate to consult with Office specialists before finalizing inherent risk assessments for the audit (refer to consultation methodology and policies in the *Consultation* section of this Manual).

Compliance with Authorities

3.84 Compliance with legislative authorities is not incorporated in APEX, so the audit team must consciously include it in the risk assessment process through other means. The inherent risk of non-compliance with authorities should be evaluated for all the significant legislative authorities the entity must comply with that could reasonably be expected to come to our notice during the conduct

of the annual audit (note: compliance with legislative authorities should not be confused with the “authorized” assertion in APEX, which has another meaning).

3.85 Another important point to recognize is that the significance and/or risk associated with a particular authority can be quite different from that of a related financial statement assertion(s) for the same component. Consequently, there may be lesser or greater testing requirements for authorities than for financial statement assertions. For example, an entity’s short-term investment program may be considered low risk for financial statement purposes, but there could be concerns that the corporate by-law governing the investing activities is not being complied with.

The Strategic Plan

General

3.86 The Strategic Plan is intended to be a concise document that touches on the significant aspects of the audit. Its value is not measured in the amount of information conveyed, but rather in its quality and its relevance. The objective is to convey the right information in the most efficient way possible.

3.87 The Strategic Plan is intended to provide sufficient detail and relevant background information to guide the Director in the development of the detailed audit programs (referred to as detailed planning). It should be an action-oriented plan, not a collection of cumulative data on the business. However, it should not duplicate what is properly done in detailed planning.

3.88 During the preparation of the Strategic Plan, a number of critical decisions are made. These decisions impact directly on the design and execution of the audit itself. Accordingly, the audit Principal should participate actively in all key strategic planning decisions. The Strategic Plan should also be reviewed and approved by the responsible Assistant Auditor General. Where appropriate, it should also be reviewed by the reference Assistant Auditor General.

ANNUAL AUDIT POLICY

The audit Principal should participate directly in all key strategic planning decisions. This should include the identification and evaluation of audit risks (including authorities and potential “other matters”) for the development of the Strategic Plan including providing instructions to staff for the preparation of audit programs. The Strategic Plan, and any significant changes thereto, should be approved by the audit Principal and reviewed by the responsible Assistant Auditor General before significant detailed planning and testing is carried out.



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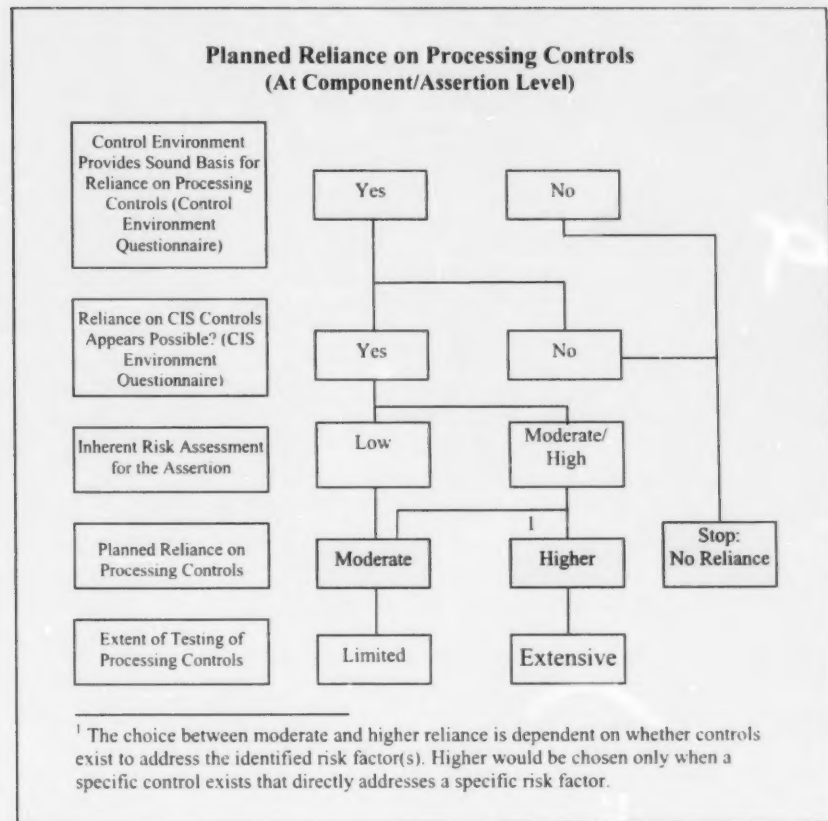
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Where audit teams do not follow the Office's preferred audit approach of reliance upon internal control as a source of audit assurance, the reasons for not following this approach should be documented in the Strategic Plan.

Determining the Planned Reliance on Controls

3.89 An important decision in developing the Strategic Plan is to determine the planned level of reliance on controls (processing, management and monitoring). This decision is based to a considerable degree on the results of assessing the control environment (through the Control Environment Questionnaire and the CIS Environment Questionnaire), combined with our cumulative knowledge of, and experience with, the entity. Under the Office's methodology, there are three possible levels of reliance: none, moderate and higher. The relationship between these levels of reliance and the corresponding control risks are as follows:

Control Risk Assessment	Risk Factor	Implied Level of Control Reliance
Low	.30	Higher
Medium	.65	Moderate
High	1.00	None



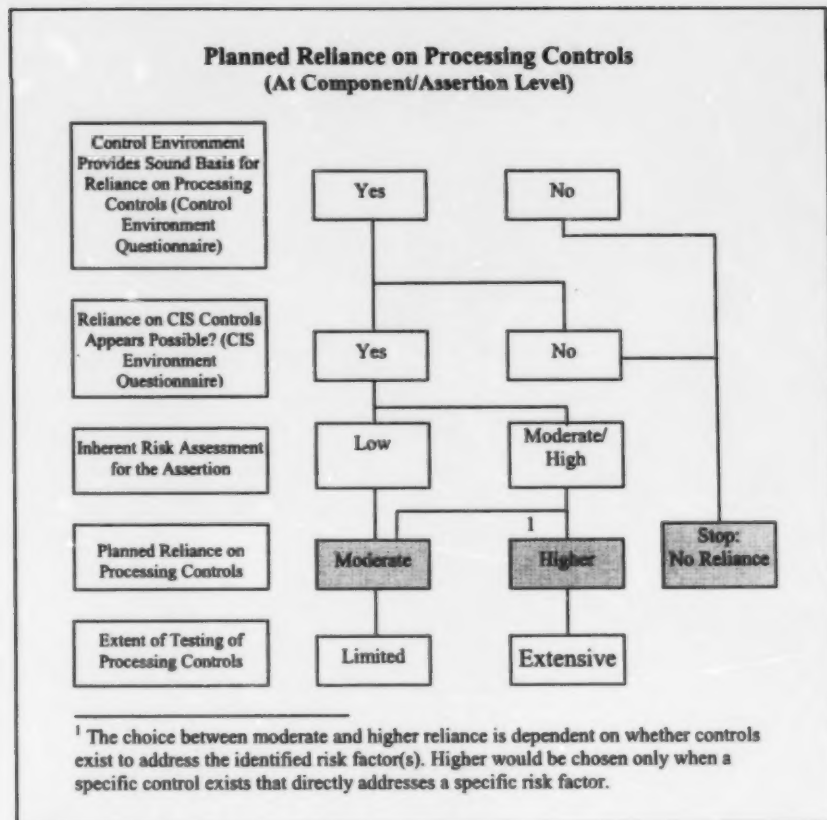
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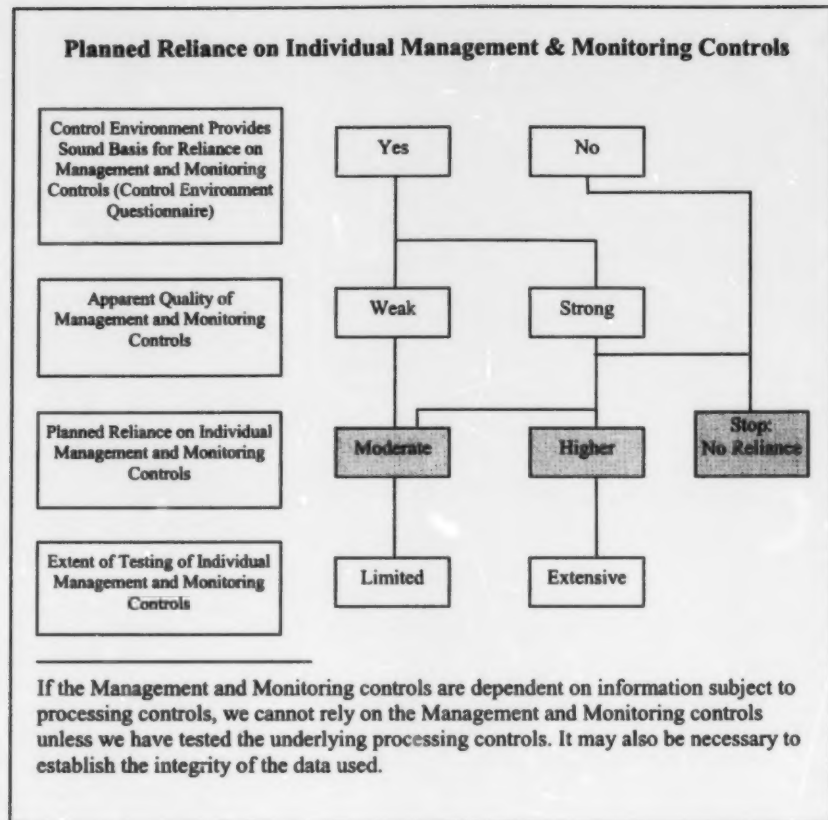
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3.90 The following table summarizes the main considerations in making preliminary decisions for components at each of the possible levels of inherent risk:

Inherent Risk Assessment for a Component	Considerations in Making Preliminary Decisions for Components
Insignificant	Little audit evidence is required. This situation normally applies to an immaterial component of the financial statements where the risk of a material error is insignificant. In this circumstance, a cost-effective audit approach would normally be to rely entirely on analytical procedures. An evaluation of controls would not likely be cost-effective.
Low	The total audit evidence required is relatively low. Analytical procedures by themselves are not likely to provide sufficient audit evidence and may need to be supplemented by reliance on processing or management and monitoring controls, or possibly by some detailed testing of transactions and balances.

	If a controls-reliant approach is warranted, a cost-effective audit approach would normally be to obtain moderate reliance on processing controls, in conjunction with reliance on management and monitoring controls and the use of analytical procedures. If controls cannot be relied upon, detailed testing of transactions and balances may be appropriate.
Moderate	A moderate amount of audit evidence is required to respond to the level of risk. Again, the use of analytical procedures will be preferred but it is unlikely that they alone will provide sufficient audit evidence. They will need to be supplemented by reliance on processing and management and monitoring controls, or by detailed testing of transactions and balances. If a controls-reliant approach is warranted, the systems update will have to be complemented by stronger management and monitoring controls and/or analytical procedures than under a "low" inherent risk assessment.
High	A significant amount of audit evidence is required. If we conclude that controls are well designed and have been placed in operation, reliance on controls is a possible option but testing of controls will likely need to be supplemented by detailed testing of transactions and balances. High risk situations typically involve components where management judgements and estimates play a significant role, making reliance on controls difficult.

Other Strategies

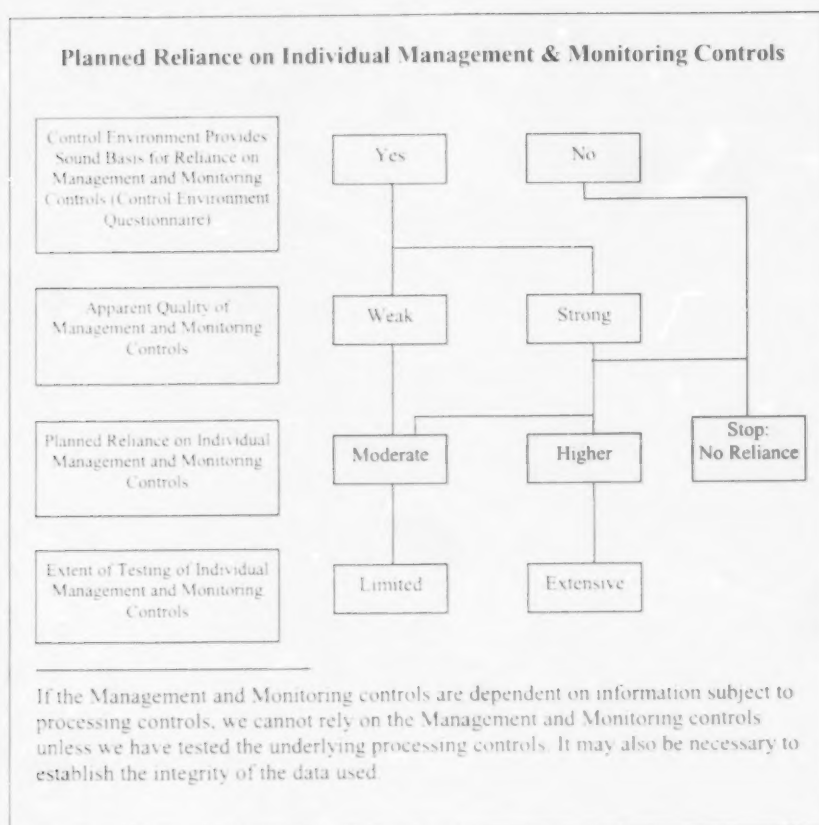
Reliance on Internal Audit

3.91 Where feasible, reliance on internal audit work is often a cost-effective source of audit assurance. Therefore, the internal audit function should be reviewed at the planning phase in order to:

- determine the extent to which the Office can rely on its work in setting the audit scope;
- co-ordinate audit work and avoid unnecessary duplication of effort; and
- determine whether detailed testing of the work carried out by internal auditors is required before placing reliance on it.

Rotation

3.92 Rotation involves reliance on prior year's audit evidence in situations where the system(s) of internal control have not changed significantly. If the audit team can establish that the audit entity is continuing to use the same computerized processing controls that were tested through a systems update in a previous year, it may be possible to limit the current year's audit work on computerized processing controls.



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3.93 The auditor would need to perform the following to take advantage of rotational opportunities:

- through enquiry and discussion with appropriately senior client officials, establish that the computerized processing controls have not changed significantly since the last systems update was performed;
- examine the environmental controls to verify that no changes have occurred, or alternatively, that the changes made have not significantly affected the key computerized processing controls upon which the auditor relied previously; and
- at year-end, ensure again that no significant changes have been made to the key controls through enquiry and discussion with senior officials.

3.94 In general, rotation should only be applied where inherent risks are considered low and where the audit team has relied previously on the computerized processing controls. Rotation is not a suitable approach for management and monitoring controls because the control procedures involve management analysis and corrective actions, which may change with management priorities and with changing business conditions. Similarly, a rotational approach may not be utilized for manual processing controls.

3.95 A rotational audit approach does not alleviate the auditor of his/her responsibility to assess the integrity of environmental controls previously discussed.

Pre-Year-End Testing

3.96 It is often advantageous to schedule as much substantive testing of transactions and balances as possible before the year-end date (e.g. for confirmation of receivables/loans). Pre-year-end testing should be done as close to the year-end date as possible, generally not more than three months before the year-end. Proper roll-forward procedures (i.e. audit tests designed to cover the period between the date of the pre-year-end substantive testing and the year-end date) should also be undertaken. As a minimum, these should include:

- ensuring that key processing and management and monitoring controls continued to be effective throughout the roll-forward period; and
- substantive tests of transactions exceeding materiality in the roll-forward period.

The Strategic Plan Document

3.97 The Strategic Plan for an audit should be a short, concise document that provides the following information, as appropriate:

- a brief description of the entity and its mandate, including identification and discussion of different business units (where applicable);
- information on the audit mandate/terms of reference for the audit;

- new or emerging accounting standards and the plan for working with the client to ensure their successful implementation;
- identification of any significant compliance with authority considerations, including any possible “other matters”, and direction on planned audit approach;
- overall planning materiality and ultimate risk decisions;
- a brief description of the overall control environment and our assessment of whether it is conducive to a controls-reliant approach;
- a brief description of the computerized information systems (CIS) environment and our assessment of the quality of the CIS general controls;
- a brief description of the areas of significant risk in the financial statements;
- any “other strategies” that are to form part of the Strategic Plan;
- key client contacts;
- reporting deadlines for the engagement;
- audit staff and budget;
- planned approach to auditing CIS systems;
- rotational audit approach, if any, and the systems that it will apply to;
- if applicable, the reasons for not following the Office’s preferred approach of reliance on controls;
- the rationale for consulting/not consulting with the Office’s Information Technology and Financial Instruments teams;
- planned use of internal audit or reliance on other auditors, if any;
- relevant findings from recently completed VFM audits, audit notes or special examinations of the entity, including how they impact the expected approach to the audit;
- any other information significant to the audit (e.g. significant accounting policies, possible legislative change);
- summary level information on the preliminary decisions for components, which includes: inherent risk assessments by assertion; the planned degree of reliance on controls; and any other specific instructions the audit Principal wants taken into consideration in detailed planning (i.e. scope, nature and extent of testing decisions). This information is normally attached as an Appendix; and
- a high level systems overview chart, as an appendix to the Plan.

3.98 The Public Accounts of Canada. For the annual audit of the Public Accounts of Canada, the specific information to include in large and small entity strategic plans is outlined in an annual planning memorandum from the Public Accounts team Principal to entity team Principals.

3.99 An Ongoing Activity. Although the preparation of the Strategic Plan is an important milestone, it should not be considered the end of audit planning. Planning is an activity that continues throughout the audit, responding to new



circumstances such as unforeseen changes in the entity's business or its systems, or unexpected results during the testing phase of the audit. Whenever such developments occur and are significant, an amendment to the Strategic Plan would normally be prepared.

3.100 Communicating the Strategic Plan. Once the Strategic Plan has been completed, it should be communicated and explained to all members of the audit team. A pre-audit team meeting is one effective way of communicating this information.

Reporting to the Audit Committee (or Equivalent)

3.101 When an Audit Committee (or its equivalent) has been appointed, we should prepare a report setting out pertinent information concerning the scope of our annual audit, our planned approach, and the matters of significance.

3.102 Not all of our annual audit entities have Audit Committees. For these audit entities, the audit team should identify another appropriate body to report its plan to, and later the results of the annual audit. For example, for the annual audit of the Public Accounts of Canada, the Office views the Public Accounts Committee as equivalent to the Audit Committee. The team conducting the annual audit of the Canadian Food Inspection Agency reports to an Audit Subcommittee of the Agency's Executive Committee.

3.103 The report for discussion with the Audit Committee should be prepared and circulated to members of the committee well in advance of the meeting. Before the report is finalized, we should provide entity senior management with the opportunity to comment on a draft of the report. This reduces the possibility of misunderstanding before meeting with the Audit Committee.

3.104 The report on our plan and approach to the audit would normally be sent under the signature of the audit Principal.

3.105 Although the terms of engagement do not typically vary significantly from year to year, our planned audit approach and the matters of potential significance would normally be expected to be more susceptible to change, particularly the latter. In addition, personnel changes in the senior management category of the entity and indeed the membership of the Audit Committee (or its equivalent) also may experience change. For these reasons, it is important to communicate with these groups and ensure they have a suitable understanding of both our audit approach and the issues expected to play a significant role in completing the audit and finalizing the financial statements.

ANNUAL AUDIT POLICY

The audit team should communicate, on a timely basis, to management of the audit entity and where one exists, the Audit Committee (or equivalent), the planned approach and matters of potential significance related to the annual audit. Where an Audit Committee (or equivalent) exists, this communication should be in writing.

circumstances such as unforeseen changes in the entity's business or its systems, or unexpected results during the testing phase of the audit. Whenever such developments occur and are significant, an amendment to the Strategic Plan would normally be prepared.

3.100 Communicating the Strategic Plan. Once the Strategic Plan has been completed, it should be communicated and explained to all members of the audit team. A pre-audit team meeting is one effective way of communicating this information.

Reporting to the Audit Committee (or Equivalent)

3.101 When an Audit Committee (or its equivalent) has been appointed, we should prepare a report setting out pertinent information concerning the scope of our annual audit, our planned approach, and the matters of significance.

3.102 Not all of our annual audit entities have Audit Committees. For these audit entities, the audit team should identify another appropriate body to report its plan to, and later the results of the annual audit. For example, for the annual audit of the Public Accounts of Canada, the Office views the Public Accounts Committee as equivalent to the Audit Committee. The team conducting the annual audit of the Canadian Food Inspection Agency reports to an Audit Subcommittee of the Agency's Executive Committee.

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3.106 Office policies dealing with communications in the broad sense are discussed in the *Communication* section of this Manual.

4

Detailed Planning and Testing

General

4.1 Once the audit Principal and Director have identified the audit risks and general approach in the strategic planning process, this information must be converted into a set of component specific audit objectives with detailed instructions as to how the objectives are to be achieved. This is referred to as detailed planning.

4.2 Detailed audit plans should be developed for each component of the financial statements. The major steps in preparing these detailed plans are:

- developing audit objectives consistent with the approach and direction provided in the Strategic Plan;
- identifying appropriate sources of audit evidence at the assertion level;
- determining the nature, extent and timing of specific audit procedures;
- negotiating the nature and timing of working papers to be prepared by the client; and
- establishing budgets and milestones for major components of the audit.

4.3 Detailed audit plans are also developed for auditing compliance with authorities. Where significant authorities have been identified during strategic planning that relate to specific financial statement components, the procedures for testing compliance should be integrated, where practicable, with the other audit procedures relating to the financial statement assertions. Authorities should not be considered as a separate, stand-alone aspect of our audit work, but rather as an integral component of it.

4.4 Audit plans are critical documents, and should be reviewed and approved by the Director, in consultation with the audit Principal.

ANNUAL AUDIT POLICY

The individual managing the detailed planning and testing, in consultation with the audit Principal, should ensure that the audit programs are consistent with the Strategic Plan and should review and approve the audit programs and any significant changes thereto.

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Compliance with Authorities and “Other Matters” — Crown Corporations and Other Entities

4.5 In carrying out testing for assessing compliance with authorities, the audit team would follow the general direction set out in the Strategic Plan and complete the specific procedures developed for the detailed audit plans. The audit Principal and/or the Director should ensure that the audit team understands the intent of all authority instruments being tested, and how the planned audit procedures are intended to allow the auditor to conclude on compliance.

4.6 When auditors encounter situations where compliance is questionable, consultation with Office specialists may be required. The particular specialist(s) that should be consulted will vary depending on the circumstances, but could include one or more of Legal Services, the Annual Audit Practice team, the Fraud Awareness Functional Responsibility Leader and the reference Assistant Auditor General. The audit team should also obtain the views of the entity senior management and, where appropriate, central agencies such as the Treasury Board.

4.7 Non-compliance with authorities is considered significant where there is a serious deviation from legislative and other authorities with respect to purpose, monetary limits and other restraints.

4.8 Although compliance is normally a yes-or-no situation, the authority paragraph in the auditor's report refers to compliance “in all significant respects”. The auditor, therefore, has to assess the significance of the non-compliance situations identified, and the attitude of the entity, as not all of them will necessarily be reported. The following factors need to be considered when evaluating the significance of a non-compliance situation:

- the significance of the deviation in relation to the dollar materiality of the transaction(s), as it may or may not be advisable to report a deviation involving small monetary amounts;
- the importance of the deviation considering the organization's legislative mandate;
- the level of importance of the authority (non-compliance with a statutory requirement is likely to be more serious than non-compliance with a by-law);
- the pervasiveness of non-compliance. For example, a situation reported only in the management letter in previous year(s) is escalating and the entity does not intend to take corrective action;
- the motivation behind the deviation, as an accidental happening, may be dealt with differently from a voluntary and deliberate non-compliance;
- the clarity of the situation. For example, a “borderline” case when there are diametrically opposed legal opinions from the entity and the Office;
- the need for reporting the situation to Parliamentarians, after giving consideration to any public or parliamentary sensitivity or known need;

- the corrective action, if any, taken by the entity (e.g., an unauthorized transaction that is subsequently approved retroactively may not warrant disclosure); or
- the impact of reporting, as the perceived role of the Office as an agent of change may influence the entity or the government to react to and change the unwanted situation.

4.9 Where the non-compliance affects the organization's relationship with other entities, central agencies or Parliament, it may be preferable to consider the non-compliance significant for reporting as an Audit Note in an Auditor General's periodic Report (refer to the *Practice Expectations Common to All Product Lines* section of this Manual).

Compliance with Authorities — Public Accounts

4.10 In the strategic planning phase of the audit, entity teams should have made a separate assessment of the inherent risk regarding the likelihood that an expenditure has been made, or revenue collected, or money borrowed that is, in all significant respects, not in compliance with the limits and/or purpose set out in the appropriation, borrowing or revenue authorities.

Testing of Limit

4.11 When the entity team has assessed the inherent risk of non-compliance with a spending authority with annual dollar limits as high, additional audit procedures as determined by the Public Accounts team should be performed. The objective of this work is to ensure that the spending authorities available for use and the overexpenditures identified by the entities have been fairly stated in the notes to the Summary Financial Statements. The notes provide aggregate information on the dollar amounts available for use and used during the fiscal year, amounts available for use in subsequent years, amounts lapsed and amounts overexpended. Details of individual votes overexpended are also provided in the notes where the overexpenditure exceeds a prescribed amount.

4.12 For non-tax revenue, discussions between the entity team and the Public Accounts team will determine the specific objectives of additional procedures to be performed, should the inherent risk of non-compliance be assessed as high.

4.13 For income tax revenues and borrowing authorities, the Revenue Canada audit team and the Finance audit team are responsible for assessing the inherent risk regarding the revenue and borrowing authorities. These entity teams will determine the specific objectives of additional procedures to be performed for the audit of the Public Accounts of Canada, should the inherent risk of non-compliance be assessed as high.

Testing of Purpose

4.14 For the audit of the Public Accounts of Canada, an authority component should be included in any spending, borrowing or revenue transaction selected for substantive verification. The objective of the work will be to form a

judgement as to whether the transaction met the intended purpose of the underlying authority.

4.15 The wording of appropriation acts is generally broad, making it difficult for auditors to assess compliance with their intended purpose. Therefore, in examining whether transactions charged to appropriations meet their intended purpose, auditors should examine such transactions in a general way by looking at whether the transaction falls within the general nature of the entity's mandate, and whether it was charged to the correct vote.

4.16 For non-tax revenues, auditors should examine transactions to ensure that the revenue has been charged in accordance with the applicable legislation and approved rates, and whether it was credited to the correct account.

4.17 For income tax revenues and borrowing authorities, the Revenue Canada team and the Finance team are responsible for determining specific procedures to be performed to assess whether the transactions met the intended purpose of the underlying authority.

Other

4.18 Votes and other authorities are normally examined in detail on a cyclical rather than an annual basis because of the sheer number of authorities and variations in their size and complexity. Nonetheless, any transactions selected for substantive verification should include an authorities component using the general approach described above.

4.19 When the auditor encounters situations where compliance is questionable, advice should be obtained, where appropriate, from the Public Accounts team Principal, Legal Services and/or the Fraud Awareness Functional Responsibility Leader.

4.20 Detailed guidance on the audit approach to compliance with legislative authorities for the Public Accounts is provided annually in the *Preface to Section 6 Audit Programs* and the audit programs prepared by the Public Accounts team.

Reliance on Processing Controls

4.21 Processing controls are manual or computer controls built into client systems so that one aspect of processing is checked by a subsequent processing step. They are applied to individual transactions or to batches of similar transactions and provide the most detailed level of control normally present in an organization. We can rely on processing controls by establishing their accuracy and effectiveness and by obtaining reasonable assurance of the consistency of their operation over the period of reliance.

4.22 Looking at processing controls from a control objective perspective, we would define processing controls as "a combination of programmed and user procedures designed to ensure only authorized data is completely and accurately processed by the system and maintained on file".

4.23 For most entities, moderate reliance on processing controls will be appropriate. Moderate reliance is obtained by performing a “systems update”, which involves documenting the system of internal control, identifying the key processing controls, performing a walkthrough, and testing those controls through the use of enquiry, inspection, observation, and limited re-performance procedures.

4.24 The “systems update” provides evidence regarding the existence and effectiveness of the key processing controls. Evidence that computerized controls operated consistently over the period of reliance requires that the auditor also ensure that the three environmental controls described in the Strategic Planning section were effective throughout the year.

4.25 There is no absolute answer as to the number of key controls that should be selected for testing, but there should be a reasonable balance between preventive controls and detective controls selected. The key controls selected should collectively address all financial statement assertions, and ideally they should overlap — that is, each assertion should be addressed by two or more key controls. Reconciliation controls are important detective controls that help to ensure the integrity of the underlying processing controls. Accordingly, important client reconciliations should be included in the “systems update” phase of our work and considered as possible key controls.

4.26 Moderate and high inherent risk assessment areas are often related to judgemental areas not subjected to processing controls. Consequently, we usually do not rely on processing controls in these areas. However, in highly complex computerized environments it may be appropriate to seek higher assurance through reliance on processing controls. The decision to seek higher control reliance is dependent on the existence of inherent risk factors that are most efficiently addressed by higher reliance on processing controls. This might apply, for example, in entities where there are few source documents but significant systems-generated transactions.

Auditing Compliance with Authorities

4.27 In components/assertions where a controls-reliant approach is being taken, work on significant authorities should be included in the “systems update” portion of the audit. Before identifying the key controls to be tested, the auditor should gain a full understanding of:

- the degree of management concern with compliance; and
- the nature of any processing controls established to ensure compliance.

Extent of Testing**Computerized Processing Controls**

Moderate Reliance	Higher Reliance
In a fully computerized environment, the system is expected to perform consistently. As long as the environmental controls have been assessed as effective, testing <u>one occurrence</u> of the control in question may suffice.	Involves extending moderate reliance by: i) selecting a larger sample for a particular control tested during moderate reliance; and/or ii) selecting additional controls which were not tested during moderate control reliance. Note: The amount of testing required will depend on the specific control(s) being tested and the nature of the risk factor.

Manual Processing Controls

Moderate Reliance	Higher Reliance
Manual processing controls may exist in: i) a mixed environment of computerized and manual controls; or ii) a completely manual environment.	
For both of the two scenarios noted above the <u>sample should be selected from throughout the period</u> . In a mixed environment, if the manual control is part of a package that includes computerized controls, testing one occurrence may suffice.	This is likely applicable only to a mixed environment, and the guidance provided above under "Computerized Processing Controls" would apply here as well.

Reliance on Management and Monitoring Controls

4.28 Management and monitoring controls focus on the outputs of the entity's systems of internal control, and give management assurance that a group or class of transactions have been processed completely, accurately and in accordance with authorized procedures. These "detective" controls are either performed or reviewed by individuals independent of the processing function. They are

generally analytical in nature and performed on a regular basis (e.g. monthly). Types of management and monitoring controls include:

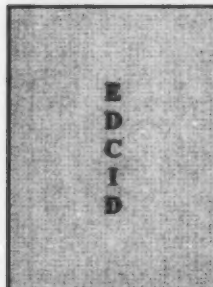
- analytical procedures (e.g. ratio analysis, comparisons of actual to budget, comparisons of actual to authorized limits); and
- systems analytics (e.g. exception reports of individually significant items).

4.29 Management and monitoring controls are efficient sources of audit evidence because they may provide assurance at the component level (i.e. they typically cover several assertions at once), and are normally limited to a few key individual controls that are effective and in place throughout the period.

Nature of Testing

4.30 Because management and monitoring controls are effectively analytical procedures, the controls can be evaluated using the same general five-step approach described in the guidance on analytical procedures in the next section. The following five “quality factors” provide the auditor with guidance in assessing how effective management and monitoring controls are likely to be and what tests of the controls would be appropriate:

Quality Factors:



Management's Expectations – what are they and do they appear appropriate?

Significant Differences – what differences trigger additional follow-up action?

Calculation – is the analytical information produced reliable and accurate?

Investigation – does management actually act when significant differences arise?

Documentation – document in the files the work performed by the auditor.

Extent of Testing

Moderate Reliance	Higher Reliance
Moderate reliance would typically include testing of one month, often the most recent month, and a review of some other months. In some cases the auditor may need to establish the integrity of the data used and the reliability of the underlying processing systems.	Higher reliance would typically include all aspects of moderate reliance plus testing more instances of the control being applied. The decision to try to obtain higher reliance should take into account the nature and quality of the control and the ease with which it can be tested.

Review versus Testing

4.31 Testing: The type of testing would depend on the category of the control, e.g., systems analytics require different testing than an analysis of performance against budget. Typically, the type of testing would be rigorous enquiry about matters arising when the control was applied, inspection of underlying documentation and ensuring that some of the key data is agreed to appropriate source documentation.

4.32 Review: Constitutes inspection of evidence of all applications of the control, but not agreeing to supporting documentation or testing any data.

Analytical Procedures

4.33 According to Section 5300 of the *CICA Handbook*, analytical procedures are techniques by which the auditor:

- studies and uses meaningful relationships among elements of financial and non-financial information to form expectations about what the recorded amounts should be;
- compares such expectations with the recorded amounts; and
- uses the results of the comparisons to help determine what, if any, other audit procedures are needed to obtain reasonable assurance that the recorded amounts are not materially misstated.

4.34 Analytical procedures, therefore, are substantive procedures involving a comparison of the recorded amount being audited to an amount that the auditor expects. The auditor's expectation of the amount is derived from his/her knowledge of relationships between the amount being audited and some other independent data. The data used in arriving at the auditor's expectation of the amount may be financial or non-financial and may originate from within or outside the entity being audited. Analytical procedures vary from simple comparisons, such as the current year's amounts (or ratios) with prior year's amounts (or ratios), to complex analysis using advanced statistical techniques and computer audit software, such as multiple regression analysis software.

4.35 The Office categorizes analytical procedures as follows:

Category	Well-suited to Public Sector?	Description	Some Key Factors to Consider
Single Component Comparisons	Yes	There are two types: • a comparison of recorded amounts against budget amounts; and • trend analysis, comparing current amounts to comparable amounts from the prior period.	If Budget: • Can budget be relied on? • Who reviews the budget? • Is the budget updated throughout the year? If Prior Year: • Has the nature of the business changed (major clients, product mix, etc.)? • What have been the economic trends in the intervening period?
Systems Analytics	Yes	Systems analytics involve the identification of unusual items within accounts rather than an analysis of the account balance taken as a whole. They include scanning or analysis of entries in transaction listings, subsidiary ledgers, general ledger control accounts, adjusting entries, suspense accounts and reconciliations.	• What is significant or unusual? • What volume of activity is normal/expected? • What is the nature of the transactions going through the account?
Independent Tests of Reasonableness	Yes	These involve the creation of an expectation using operating or external data (independent of the accounting process) as well as financial data to predict an amount under examination, for example, using employee head counts and average remuneration statistics to predict payroll expense.	• Can the balance be predicted using an external factor? • How relevant is the external data source to the entity's business? • Can we rely on the accuracy of internally generated operational statistics?

Category	Well-suited to Public Sector?	Description	Some Key Factors to Consider
Cross Component Comparisons	No	These involve the analysis of the relationship of two or more financial statement variables. Usually this is referred to as ratio analysis. Examples include accounts receivable turnover and gross margin analysis.	- Relationships between components. - Changes in entity policies (i.e. credit policies). - Knowledge of what events impact the numbers. - Changes in the business environment.
Regression Analysis	No (except for payroll)	Regression is a statistical technique that involves analyzing the known behavior of variables and developing an equation (model) that explains the average relationship between these variables. A regression model is similar to an independent test of reasonableness, but it is more objective and provides a reliable estimate of an acceptable range of fluctuation. For example, historical monthly staffing by level is regressed against average monthly salary levels to develop a model that predicts payroll expense.	- Many of the factors relating to independent tests of reasonableness apply to regression as well. - If there is a history of errors in the data used, the formula will incorporate them and predict poorly.

4.36 Factors that affect the degree of substantive assurance that can be derived from a particular analytical procedure are:

- the sophistication of the procedure used;
- the plausibility and predictability of the underlying relationship between the amounts used for comparison; and
- the extent to which the data used are independent, verifiable, relevant and reliable.

4.37 It should be emphasized that the Office is looking for rigorous, thoughtful, quantitatively-based analyses that provide substantive assurance. A

five-step approach has been developed to help guide auditors in developing a suitably rigorous approach:

5-STEP APPROACH	
E	1. Develop an expectation ;
D	2. Define a significant difference (e.g. 50% of planned precision for annual data, 20% of planned precision for monthly data);
C	3. Perform the calculation ;
I	4. Investigate significant differences (explaining to at least one-half of whatever you defined as a significant difference); and
D	5. Document the procedures performed.

4.38 Strong support and involvement is needed from the audit Principal and Director to ensure that the analytical procedures used are conceptually sound and take into account all factors that could or should result in large changes in specific components.

Substantive Tests of Detail

General

4.39 When sufficient audit evidence cannot be efficiently obtained through auditing a combination of processing controls, management and monitoring controls and/or through analytical procedures, or in the relatively few cases where inherent risk is assessed as moderate or high, it is appropriate to turn to substantive tests of detail. Those tests provide evidence to support management's assertions with respect to the amounts reported in the financial statements through:

- tests of detail of individually significant balances and transactions; and
- tests of detail using representative sampling.

4.40 The primary disadvantage of substantive tests of details is that each individual audit step or test generally addresses only one assertion at a time.

4.41 Substantive tests are often the most appropriate way to test compliance with authorities. This relates, in large part, to the fact that an authority requirement has either been complied with or it has not — often, there is no middle ground. As well, some authority requirements do not lend themselves to a controls-reliant approach, for example the requirement for Ministers responsible for Crown corporations to table before Parliament a summary version of the corporation's Corporate Plan.

Audit Sampling

4.42 Individually significant balances and transactions can be divided into two groups: high-value (HV) items and other items. Generally, any item that,

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Audit Sampling

4.42 Individually significant balances and transactions can be divided into two groups: high-value (HV) items and other items. Generally, any item that,

individually, has a high risk of containing an error exceeding materiality should always be examined.

4.43 Representative sampling procedures can be performed either statistically or non-statistically. The main difference between the two methods is limited to the rigour in which the representative samples are selected. The process used in determining sample extent and evaluating results should be similar under both methodologies. Ultimately, the approach selected for use should be the one expected to be more cost-effective in the particular circumstances, after considering the need to ensure completeness of population from which the sample is selected. Where practical, a dollar unit sampling (DUS) approach would normally be followed. Should a non-statistical approach be used, the sample size should be at least as large as that which would have been used under a DUS approach, and preferably larger.

4.44 When a sampling approach is selected, the audit Principal should expect his staff to have defined the following items before carrying out procedures:

- the purpose (objective) of the procedure, including the assertion(s) being addressed;
- the population from which the sample will be selected;
- the physical unit to be selected;
- what will constitute an error; and
- the confidence level (i.e. sampling risk) for the procedure.

4.45 Two other important sampling inputs are materiality and planned precision. Materiality, defined in the strategic planning phase, relates to the maximum allowable error. What the auditor normally plans to do is perform enough work to conclude that, based on the results of all the audit tests, the chance of the maximum possible error exceeding materiality is less than or equal to the ultimate audit risk the auditor is willing to assume.

4.46 This means, for example, that the auditor cannot simply equate the net most likely errors to materiality; there must be an allowance for further possible errors. This allowance is referred to as the "precision". Planned precision is determined at the strategic planning phase, as illustrated below:

Planned Precision Illustrative Example		Overstating (Understating) current year's income
Materiality for the engagement		\$ 300,000
1) Expected aggregate errors in current year's net income (Net of the reversing impact of prior years' errors)	\$ 50,000	
2) Cushion to allow for fact that current year-end audit results may exceed those anticipated in (1)	20,000	70,000
Planned precision (should normally not be less than half materiality, in this case \$150,000)		\$ 230,000

Extent of Testing Decisions

4.47 The extent of testing will be performed at one of three levels: limited, extensive or complete. Specific testing options are outlined in the table below:

"RULES OF THUMB"

Extent of Testing	Required Level of Audit Work
Limited	- Representative sample (normally statistical via DUS) using a 70% confidence level; OR - High value selection with a coverage by \$ value of between 40% and 80%. <i>Note:</i> If the remaining unaudited coverage is > twice materiality then the total selection should be at least 30 items.
Extensive	- Representative sample (normally statistical via DUS) using a 90% confidence level; OR - HV selection with a coverage by \$ value of 80% or more (including all items > materiality) and remaining unaudited coverage is not > twice materiality.
Complete	Essentially 100% testing of the full population.

4.48 In some cases, the auditor may decide to follow a strictly substantive audit approach based solely on analytical procedures and on substantive tests of detail. In that case, the auditor should generally choose either the "limited" or the "extensive" option, the choice depending on the quality of the analytical procedures being performed and the auditor's assessment of inherent risk. Where inherent risk for a particular component or assertion is assessed as high, the audit Principal may wish to consider other options, such as complete testing or the use of statistical sampling based on some other confidence interval.

Other Evidentiary Matters

Management Letter of Representation

4.49 A basic assumption of auditing is that management is operating in good faith and providing us with all the relevant information at their disposal. Should information come to the auditor's attention that these basic assumptions are not warranted, significantly more audit work is required in order for us to provide our report.

4.50 We normally obtain sufficient appropriate audit evidence to support these important assumptions through two means. Our primary source of evidence is obtained through testing and other procedures (e.g. analytical review). A secondary but nevertheless important source of evidence is referred to as the "letter of representation" or as the "management representation" letter. It is a letter addressed to the auditor and signed by senior entity management officials, one of whom should be the senior full-time financial officer. These senior managers provide assurances (or "representations") to the auditor about key aspects of each significant financial statement component. In addition, other key representations are made including, for example, the completeness and accuracy of all information provided, the existence (or lack thereof) of subsequent events and, where appropriate, confirmation of management intentions.

4.51 A letter of representation should be obtained for every audit, and should bear the date of substantial completion of fieldwork.

ANNUAL AUDIT POLICY

The audit team should obtain a letter of representation from the appropriate level of management as at the date of substantial completion of fieldwork.



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5

Reporting

Evaluating Audit Results

Audit Differences Identified in the Financial Statements

5.1 As the fieldwork is being completed the audit team should be accumulating and summarizing any errors found during testing. The purpose is to estimate the likely aggregate misstatement in the financial statements. The likely aggregate misstatement is estimated by summing:

- a) misstatements identified as a result of performing specific auditing procedures on other than representative samples;
- b) projections of misstatements identified as a result of performing auditing procedures on representative samples;
- c) disagreements with accounting estimates; and
- d) the net effect of uncorrected misstatements in opening equity.

5.2 For the annual audit of financial statements that apply the recommendations of the Public Sector Accounting Handbook, PS 2120, ACCOUNTING CHANGES suggests a different approach to the treatment of errors on the overall error evaluation. A discussion paper on the impact of PS 2120 can be found on the QMS Annual Audit Intranet Site, under Conduct of the Audit — Public Accounts (Section 6), FRL Guidance.

5.3 The Office has designed several “Summary of Unadjusted Differences” PAD forms in order to present unadjusted differences in such a way that facilitates evaluating whether, in relation to individual amounts, subtotals, or totals in the financial statements, they materially misstate the financial statements as a whole. The audit Principal should review the Summary of Unadjusted Differences and ensure that the audit team has properly accumulated and evaluated the results. The audit Principal should also give due consideration to further possible misstatements, possible overall management bias in accounting estimates, significant changes in bias from one period to the next, and the potential impact on future years’ results of differences identified in the current year.

5.4 For the annual audit of the Public Accounts of Canada, the Public Accounts team has developed an error-reporting module in ATTEST to accumulate errors found during the audit. All large and small entity teams as well as the Public Accounts team are required to enter errors on the appropriate error

form in ATTEST. For micro and separate opinion entities, audit teams are required to record any errors found on the appropriate error form as provided by the Public Accounts team. A threshold for the reporting of errors by large and small entity teams has been established by the Public Accounts team as documented in the *Main Audit Program*. The responsibility for overall error evaluation rests with the Public Accounts team.

Evaluating Compliance with Authorities and “Other Matters”

General

5.5 The audit team should also evaluate whether the authority requirements identified during the strategic planning phase have been complied with in all significant respects. In testing specific authorities, it is important for auditors to recognize that either the authority has been complied with, or it has not. Unlike a detailed test of a transaction, where the valuation assertion may be understated or overstated by a wide range of values, a given authority normally has only two possibilities: complied with, or not complied with.

5.6 Considerable judgement is required in assessing whether or not a potential instance of non-compliance with authorities is a reportable matter. When identifying the significant authority requirements at the strategic planning phase, the audit team has already made a preliminary assessment of those instances considered reportable in either the auditor’s report or in the management letter. Accordingly, it is important that, whenever a possible instance of non-compliance comes to the attention of the auditor, the following steps are taken:

- the auditor re-confirms their understanding of the authority requirement through discussion with the responsible Director and/or audit Principal;
- the facts of the matter are verified with the appropriate entity official(s); and
- the existence of any other evidence pertinent to the matter is confirmed.

5.7 All potential cases of non-compliance with authorities should be referred to the audit Principal for assessment and resolution. Such situations often involve legal interpretation of the relevant facts of the case, and this will normally require consultation with Legal Services. Responsibility for ensuring that Office protocol is followed, and that resolution of the matter is properly documented, rests with the Director and the audit Principal (refer to consultation methodology and policies in the *Consultation* section of this Manual).

5.8 Issues that may be “other matters” are also generally complex and difficult to evaluate. Generally, a process similar to that recommended for evaluating compliance with authority issues should be followed. That is:

- the facts should be reconfirmed through discussion with the client;
- there should be consultation with specialists in the Office, as appropriate;

- the critical factors used in arriving at our conclusion should be explained; and
- the “other matter” and its final resolution should be properly documented.

Reporting Compliance with Authorities and “Other Matters”— Crown Corporations and Other Entities

5.9 Reporting the results of auditing the compliance with authority must be in accordance with the legislative audit mandate or the terms of the engagement. For Crown corporations, non-compliance with the authorities specified in the *FAA* would be reported in the compliance paragraph as a reservation. Non-compliance with other authorities would be reported as “other matters”.

5.10 The standard Office wording of auditor’s reports for Crown corporations is used where there are no reservations.

5.11 Depending on the significance of the non-compliance situation and results of discussions with the entity, any reservation of opinion could be presented in one of the following ways:

- a description of the situation in a separate paragraph between the opinion on the fairness of the financial statements and the opinion on compliance with authority, with an “except for” and reference to the reservation paragraph in the opinion on compliance paragraph; or
- a brief description of the non-compliance situation in the compliance paragraph, with the use of “except for”.

5.12 It is advisable that any situation of non-compliance not included in the auditor’s report be included in the management letter and fully discussed with management and the board of directors or its audit committee.

5.13 The audit team would also consider the appropriateness of developing an Audit Note for potential inclusion in an Auditor General’s periodic Report (refer to the *Practice Expectations Common to All Product Lines* section of this Manual) based on the instance of non-compliance referred to in our Auditor’s Report.

Reporting Compliance with Authorities — Public Accounts of Canada

5.14 The results of all compliance with authority work carried out by the Office should be considered in assessing overall audit assurance and in formulating the opinion and observations on the Summary Financial Statements.

5.15 All compliance with authority work, whether under value-for-money audits or Crown corporation and other separate opinion audits, provides audit assurance in auditing the Summary Financial Statements of Canada. Annually, the FRL for Fraud Awareness and Authorities will call for information from all Principals on authority work conducted and issues observed throughout the year. The FRL and the Public Accounts team Principal will review this information for

possible inclusion in the Report Clearance Memorandum (RCM) and observations, as may be appropriate.

5.16 On rare occasions, an authority issue may be of such significance that it is necessary information for the users of the Summary Financial Statements of Canada. In such circumstances, the issue would be considered for inclusion in the Auditor General's observations on those statements.

5.17 Except as noted in the above paragraph, issues identified through this process may not be significant in relation to the audit of the Summary Financial Statements. However, they may be reported in a departmental management letter, an audit note or as part of a value-for-money chapter. Significance in this sense means that a major deviation from the purpose of the legislation has been noted and/or that monetary limits established by Parliament have been exceeded and not reported.

Reference Assistant Auditor General Review

5.18 For certain audits, the Office has appointed a reference Assistant Auditor General (AAG) in order to provide an enhanced level of quality assurance. The reference AAGs have been assigned to audits perceived to be: of higher risk; complex to conduct; sensitive in nature; or having complex accounting issues. Reference AAGs have significant experience in the Office and have no direct involvement in the particular annual audit(s) they are assigned to. Accordingly, they provide an additional element of independence and objectivity in key risk areas related to reporting the annual audit.

5.19 Through the review of key documents, primarily the financial statements, reports to the audit committee and the Report Clearance Memorandum, they will focus their attention on the following reporting matters:

- appropriateness of the accounting policies adopted;
- impact of new/emerging accounting standards on the audit entity's financial statements, where appropriate;
- financial statement presentation/disclosures;
- appropriateness of the auditor's report; and
- Office positions on complex, controversial and/or politically sensitive issues.

5.20 The nature and extent of involvement by the reference AAG is to be determined on a case-by-case basis. In normal circumstances, the reference AAG would not be expected to require access to audit files. The "client" for the reference AAG is the primary AAG and audit Principal. However, in those rare instances where the reference AAG and the primary audit team disagree on a particular course of action, the disagreement would be referred to the Auditor General for resolution.

5.21 The list of reference AAGs and their respective audit entities is available from the Annual Audit Intranet site.

ANNUAL AUDIT POLICY

On those audits for which a reference Assistant Auditor General has been established, the responsible Assistant Auditor General and such Principal should consult with the reference Assistant Auditor General on significant risks and any other matters of a complex or controversial nature. Consultation should begin at the strategic planning stage of the audit and continue, as required, throughout the audit including consultation on the draft auditor's report and draft financial statements.

Annual Audit Practice Review

5.22 The Annual Audit Practice (AAP) financial statement review has two broad objectives: to ensure that there is a consistent approach to significant audit issues throughout the Office and to ensure that auditor's reports conform to professional reporting standards and are appropriate to the financial statements presented.

5.23 AAP's specific responsibilities in the review of the financial statements and the auditor's report are to assess:

- the clarity, accuracy and completeness of the financial statements and accompanying notes;
- the appropriateness of the financial statements presented in meeting the needs of the entity's users and conforming with all legal and professional reporting requirements; and
- the appropriateness of the auditor's report.

5.24 To facilitate AAP team's review, the audit Principal is responsible for reviewing the draft financial statements and auditor's report. Subsequent to his/her review, the audit Principal will provide AAP with the following:

- draft auditor's report;
- draft financial statements, including notes;
- draft report clearance memorandum (including a summary of discussions with the client on any significant reporting issues); and
- information on the resolution of issues raised in prior years' AAP memoranda that were deferred.

5.25 AAP will review the appropriateness of the auditor's report, taking into account the financial statement presentation and format; the accounting principles followed; the clarity, accuracy and completeness of notes to the financial statements; and all other information presented to them. Based on discussions with the audit Principal, AAP will prepare a memorandum to the audit Principal summarizing the results of the review and providing advice in areas where AAP believes the statements and/or the auditor's report could be improved. When there is mutual agreement on the issues raised in the AAP

review memorandum, the audit Principal and AAP co-sign it. If the audit Principal declines the advice offered, then the audit Principal, after consultation with AAP, will present the relevant facts to the AG/DAG/AAG, as appropriate, for resolution.

5.26 Consultation methodology and policies are discussed more fully in the *Consultation* section of this Manual.

ANNUAL AUDIT POLICY

For the audit of Crown corporations and other entities, the audit Principal should consult with the Annual Audit Practice team on the draft Auditor's Report, draft financial statements, and matters of significance related to our report. The audit Principal should document his/her disposition of any advice received from the Annual Audit Practice Team prior to recommending signature of the Auditor's Report.

The Public Accounts of Canada

5.27 The Auditor General's Independent Advisory Committee provides an independent review of any new notes or significant changes to the Summary Financial Statements of Canada. Accordingly, these financial statements are not required to be reviewed by the Annual Audit Practice team.

Sensitive Issues

5.28 All sensitive issues should be brought to the attention of the Auditor General prior to the signing of the auditor's report. Sensitive issues would include such matters as reservations of opinion, controversial professional positions or other matters with the potential for broader implications beyond the audit entity alone. This ensures that the Auditor General is comfortable with the positions taken by the Office, or alternatively, that he is able to consult further within the Office, with other jurisdictions or with other professionals should he/she consider such consultation advisable.

ANNUAL AUDIT POLICY

The audit Principal should brief the Auditor General on any sensitive issues (reservations of opinion, controversial professional positions, etc.) prior to the signing of the Auditor's Report.

Report Clearance Memorandum

5.29 The Report Clearance Memorandum (RCM) provides a framework for the audit Principal to document completion and clearance of an annual audit (or of a special audit engagement) and a basis for the necessary reviews and approvals. To do so adequately, the RCM should:

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On those audits for which a reference Assistant Auditor General has been established, the responsible Assistant Auditor General and audit Principal should consult with the reference Assistant Auditor General on significant risks and any other matters of a complex or controversial nature. Consultation should begin at the strategic planning stage of the audit and continue, as required, throughout the audit including consultation on the draft auditor's report and draft financial statements.

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- information on the resolution of issues raised in prior years' AAP memoranda that were deferred.

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- highlight significant aspects of the entity's operations;
- set out key decisions made during the audit;
- identify any contentious or sensitive issues; and
- provide an overview of audit performance.

5.30 The RCM is normally prepared under the direction of the audit Principal. Before being finalized and presented for signature, a draft should normally be reviewed by the Reference Assistant Auditor General (if any). If the RCM is to be signed by the Auditor General or by the Deputy Auditor General, the responsible Assistant Auditor General should also approve it.

5.31 The AAP team is also to be provided with a copy of the RCM. Where there are unresolved differences of opinion between the audit team and the AAP team, the AAP team should be provided with the opportunity to review and provide comments on the draft RCM before it is finalized.

ANNUAL AUDIT POLICY

The audit team should prepare a Report Clearance Memorandum (RCM) to document the completion of the audit and to recommend signature of the Auditor's Report. The audit Principal and the responsible Assistant Auditor General should approve the RCM and it should be reviewed by the individual with delegated signing authority for the Auditor's Report.

5.32 For the annual audit of the Public Accounts of Canada, only one RCM is prepared, under the direction of the Public Accounts team Principal. Entity teams may be requested by the Public Accounts team to provide specific information for inclusion in the RCM. Where there are unresolved differences of opinion between the Public Accounts team and the entity team, the entity team should be provided with the opportunity to provide comments for inclusion in the RCM.

Recommendation for Signature

5.33 The lead sheet of the RCM contains the recommendation by the audit Principal (and if appropriate, the AAG) that the (Deputy/Assistant) (Auditor General) sign the auditor's report as presented. A specific PAD provides standard wording and specifies matters on which explicit representations are required. The individual responsible for giving final clearance to the auditor's report is determined according to the Office's approved delegation of authority for signing annual Auditor's Reports.

5.34 Those reviewing and signing the Report Clearance Memorandum (Deputy/Assistant/Auditor General) want to know by glancing at the form whether there are any exceptions to the audit Principal's representations made in the RCM. Therefore, the standard sign-off sheet should always be used, with any exceptions clearly identified, ideally through the use of *strikeout*.

Signing the Auditor's Report

5.35 The Office has developed a delegation of signing authority for the auditor's reports of its annual audits. This delegation of authority is available from the Annual Audit Intranet site.

ANNUAL AUDIT POLICY

The audit team should obtain the signature for the Auditor's Report in accordance with the Office's delegation of signing authority for annual audits.

Review of the Annual Report

5.36 Whenever our auditor's report is to be included in an annual report or other published document, we should arrange to read the other information to ascertain that, based on our audit of the financial statements, we believe it to be free of any material misstatement of fact or material inconsistencies with information appearing in the financial statements. Where we believe that it is materially misleading or inconsistent, we should attempt to convince management (or the directors) to correct the other information. If the required corrections are not made, it may be necessary to refuse to sign or to withhold the use of our report. This review should be completed while the annual reports or other documents are in draft form, in order to permit any concerns the auditor may have to be acted upon before the document is finalized and printed.

5.37 Many audit entities now post their annual reports, including their audited financial statements, on the Internet. For those entities, it is important to ensure that they have appropriate controls in place to ensure that the financial statements posted to the Internet are accurate and complete, and to prevent unauthorized changes to information. The auditor may wish to test these controls during the audit to gauge whether reliance on them is appropriate.

5.38 The auditor should also take appropriate steps to ensure that the audit entity has accurately reproduced the financial statements, including the auditor's report, on the Internet. There should also be some "substantive" testing of the financial information posted and a complete review of the posted auditor's report.

5.39 We should ascertain early in the audit whether the client intends to post the audited financial statements on the Internet, and ensure that they are aware of the associated risks and need for adequate control procedures.

Reporting to the Audit Committee

5.40 The audit Principal should prepare a formal written report to the audit committee outlining the results of the examination of the entity's annual financial statements and discussing all matters likely to be of significance or concern to the members. Some of the more important areas to discuss include:

- highlight significant aspects of the entity's operations;
- set out key decisions made during the audit;
- identify any contentious or sensitive issues; and
- provide an overview of audit performance.

5.30 The RCM is normally prepared under the direction of the audit Principal. Before being finalized and presented for signature, a draft should normally be reviewed by the Reference Assistant Auditor General (if any). If the RCM is to be signed by the Auditor General or by the Deputy Auditor General, the responsible Assistant Auditor General should also approve it.

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- scope of the completed audit;
- significant management judgements and estimates;
- the auditor's report being submitted;
- results of the review of the annual report;
- follow-up to any matters of audit significance identified in the planning report to the audit committee;
- significant misstatements identified; and
- disagreements with management.

5.41 The report to the audit committee should be provided to senior management of the entity for review and comment prior to being finalized.

ANNUAL AUDIT POLICY

The audit team should prepare and communicate, on a timely basis, to the audit committee (or equivalent) where one exists, a written report describing the results of the audit and any significant observations and recommendations arising from the annual audit.

5.42 Office policies dealing with communications in the broad sense are discussed in the *Communication* section of this Manual.

Management Letters

5.43 During our audits we frequently identify opportunities where audit entities could improve their systems of internal control and/or strengthen their financial and reporting practices. These observations are important to entity managers, and the auditor has a professional obligation to ensure that the appropriate level of management is made aware of them. This may be done orally or via a management letter.

5.44 Management letters may be written in point-form or in long-form. Individual management letter points should include a clear description of the observation, the consequences of the observation, recommendations for improvement and comments of managers responsible for taking corrective action.

5.45 Management letters should normally be prepared under the signature of the responsible audit Principal, and be reviewed and approved in advance by the responsible Assistant Auditor General.

5.46 For the annual audit of the Public Accounts of Canada, management letters are issued by audit entity teams and by the Public Accounts team. The Public Accounts team management letter is directed at Treasury Board, Finance and the Receiver General, who are jointly responsible for preparing the Summary Financial Statements of Canada.

5.47 Matters significant enough to be reported should be followed up in subsequent audits.

ANNUAL AUDIT POLICY

The audit team should communicate, on a timely basis, to management of the audit entity, the results of the audit and any significant observations and recommendations arising from the annual audit. This communication should be in the form of a management letter unless another form of communication is approved by the audit Principal.

5.48 Office policies dealing with communications in the broad sense are discussed in the *Communication* section of this Manual.

- scope of the completed audit;
- significant management judgements and estimates;
- the auditor's report being submitted;
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6

Consultation

6.1 We operate in a complex environment that frequently requires teamwork, specialized knowledge and the wisdom gained from the experience of others. The Office's *Quality Management System* explicitly recognizes the contributions and strengths various groups in the Office may bring to bear in conducting quality annual audits, by establishing general standards regarding whom should be consulted and when. It is rarely possible for one individual, or even a very strong audit team, to know everything that is required in order to ensure that all aspects of our *Quality Management System* have been adhered to in a given annual audit. As well, the profession has long recognized the value of sober second thought and independent review and challenge of contentious, difficult and/or complex issues. For these reasons, consultation is an important element of every annual audit.

6.2 The Office has a history of working together and utilizing the knowledge and collective expertise of its staff. We have a strong corporate culture whereby difficult and/or contentious issues are resolved in a collaborative and consensus-building fashion. Our quality management system works in concert with this culture by requiring consultation in high risk situations or in situations where audit teams could not reasonably be expected to have the requisite expertise to deal with specialized issues.

ANNUAL AUDIT POLICY

The audit Principal should consult with internal and external specialists and senior Office staff, as necessary, when dealing with unusual, complex or controversial issues, or other matters requiring specialized knowledge or experience.

Auditor General on Sensitive Issues

6.3 The Auditor General should always be consulted on significant matters of a sensitive nature before Office positions are finalized. Examples of such sensitive matters would include:

- any proposed reservations of opinion;
- taking a position on issues controversial within the profession;

- dealing with matters for which professional guidance currently does not exist; and
- issues which could affect a significant segment of our annual audit practice.

6.4 Sensitive matters should be brought to the attention of the Auditor General even though the audit team and other specialists consulted are in agreement with the positions being adopted.

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The audit Principal should brief the Auditor General on any sensitive issues (reservations of opinion, controversial professional positions, etc.) prior to the signing of the Auditor's Report.

“Reference” Assistant Auditor Generals

6.5 For certain audits, the Office has appointed a reference Assistant Auditor General (AAG) in order to provide an enhanced level of quality assurance. The reference AAGs have been assigned to audits perceived to be: of higher risk; complex to conduct; sensitive in nature; or having complex accounting issues.

6.6 Reference AAGs have significant experience in the Office and have no direct involvement in the particular annual audit(s) they are assigned to. Accordingly, they provide an additional element of independence and objectivity in key risk areas related to planning, conducting and reporting the annual audit. Through the review of key documents including the Strategic Plan for the audit, the financial statements, reports to the audit committee and the Report Clearance Memorandum, they will focus their attention on the following matters:

- identification of risk factors;
- audit approach for key areas;
- impact of new/emerging accounting standards;
- accounting policies adopted and financial statement presentation/disclosures; and
- Office positions on complex, controversial and/or politically sensitive issues.

6.7 The nature and extent of involvement by the reference AAG is to be determined on a case-by-case basis. In normal circumstances, the reference AAG would not be expected to require access to audit files. The “client” for the reference AAG is the primary AAG and audit Principal. However, in those rare instances where the reference AAG and the primary audit team disagree on a particular course of action, the disagreement would be referred to the Auditor General for resolution.

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6.3 The Auditor General should always be consulted on significant matters of a sensitive nature before Office positions are finalized. Examples of such sensitive matters would include:

- any proposed reservations of opinion;
- taking a position on issues controversial within the profession;

- dealing with matters for which professional guidance currently does not exist; and
- issues which could affect a significant segment of our annual audit practice.

6.4 Sensitive matters should be brought to the attention of the Auditor General even though the audit team and other specialists consulted are in agreement with the positions being adopted.

ANNUAL AUDIT POLICY

The audit Principal should brief the Auditor General on any sensitive issues (reservations of opinion, controversial professional positions, etc.) prior to the signing of the Auditor's Report.

“Reference” Assistant Auditor Generals

6.5 For certain audits, the Office has appointed a reference Assistant Auditor General (AAG) in order to provide an enhanced level of quality assurance. The reference AAGs have been assigned to audits perceived to be: of higher risk; complex to conduct; sensitive in nature; or having complex accounting issues.

6.6 Reference AAGs have significant experience in the Office and have no direct involvement in the particular annual audit(s) they are assigned to. Accordingly, they provide an additional element of independence and objectivity in key risk areas related to planning, conducting and reporting the annual audit. Through the review of key documents including the Strategic Plan for the audit, the financial statements, reports to the audit committee and the Report Clearance Memorandum, they will focus their attention on the following matters:

- identification of risk factors;
- audit approach for key areas;
- impact of new/emerging accounting standards;
- accounting policies adopted and financial statement presentation/disclosures; and
- Office positions on complex, controversial and/or politically sensitive issues.

6.7 The nature and extent of involvement by the reference AAG is to be determined on a case-by-case basis. In normal circumstances, the reference AAG would not be expected to require access to audit files. The “client” for the reference AAG is the primary AAG and audit Principal. However, in those rare instances where the reference AAG and the primary audit team disagree on a particular course of action, the disagreement would be referred to the Auditor General for resolution.

6.8 The list of Reference AAGs and their respective audit entities is available from the Annual Audit Intranet site.

ANNUAL AUDIT POLICY

On those audits for which a reference Assistant Auditor General has been established, the responsible Assistant Auditor General and audit Principal should consult with the reference Assistant Auditor General on significant risks and any other matters of a complex or controversial nature. Consultation should begin at the strategic planning stage of the audit and continue, as required, throughout the audit including consultation on the draft Auditor's Report and draft financial statements.

The Annual Audit Practice (AAP) Team

6.9 There are four major services provided by the AAP team to the audit teams. These are:

- ensuring that there is a consistent approach to significant audit issues throughout the Office;
- ensuring the auditor's reports conform to the professional reporting standards and are appropriate to the financial statements presented;
- assisting teams in identifying sources of specialized industry knowledge; and
- providing advice on the application of the Office's methodology, guidance and tools.

6.10 Key points of the audit where consultation with the AAP team is expected are discussed below.

Terms of Engagement

6.11 One area where consistency is important is in establishing terms of engagement for our annual audits. There are numerous pieces of legislation that mandate annual audit work to be performed by the Office. To the extent permitted by the wording of the legislation we should strive to establish a consistent understanding with audit entities in relation to the terms of our annual audit engagement. The AAP team is uniquely positioned to provide advice in this area.

6.12 Occasionally we are given a mandate by Parliament to undertake new annual audits, for example through the creation of new agencies or federal corporate bodies. The Governor in Council may also request the Office to perform annual audit work pursuant to Section 11 of the *Auditor General Act*. As well, audit entities may ask us to undertake work that is in addition to our normal mandate. In these circumstances, consultation with the AAP team and with Legal Services (see the *Practice Expectations Common to All Product Lines* section of this Manual) should take place.

6.13 Consultation is important to ensure that:

- an appropriate legal basis exists for the work;
- recent developments in the profession have been considered; and
- new or proposed engagements are conducted on a basis similar to other engagements in our portfolio, where appropriate.

ANNUAL AUDIT POLICY

The audit team should consult with the Annual Audit Practice team on the terms of engagement of new or proposed annual audit engagements.

Planning

6.14 At the planning stage, the AAP team can provide valuable input in assessing the significance of potential reporting issues the audit team has identified, and in suggesting how the issues should be conveyed to the audit committee in the team's planning report. The AAP team can also perform a preliminary assessment of the issue early in the audit and identify the nature and extent of additional information needed to finalize an Office position on the matter.

Access to Specialized Knowledge/Expertise

6.15 Our portfolio of clients is unique, and we have many entities operating in specialized industries where the only comparable organizations are in the private sector. As well, these entities may follow unusual or unique accounting practices. In situations where the audit Principal needs access to additional sources of industry information in order to acquire an appropriate knowledge of the business, the AAP team can help identify specialists and sources of industry information, internally and externally.

Review of Financial Statements and Auditor's Report

6.16 In its review of the financial statements and the auditor's report, the Annual Audit Practice team is responsible for assessing the consistency of accounting and reporting matters across entities which the Office is responsible for auditing. In carrying out this responsibility, the AAP team also provides advice to the audit Principal on:

- the clarity, accuracy and completeness of the financial statements and accompanying notes;
- the appropriateness of the financial statements presented in meeting the needs of the entity's users and conforming with all legal and professional reporting requirements; and
- the appropriateness of the auditor's report.

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- the clarity, accuracy and completeness of the financial statements and accompanying notes;
- the appropriateness of the financial statements presented in meeting the needs of the entity's users and conforming with all legal and professional reporting requirements; and
- the appropriateness of the auditor's report.



6.17 To facilitate the AAP team's review, the audit Principal is responsible for reviewing the draft financial statements and auditor's report. The team should only forward the full financial statements to the AAP team once their initial review has been completed and they have discussed any proposed changes with the audit entity. The audit entity should also be made aware that further changes to the financial statements may be required pursuant to the AAP team's review.

ANNUAL AUDIT POLICY

For the audit of Crown corporations and other entities, the audit Principal should consult with the Annual Audit Practice team on the draft Auditor's Report, draft financial statements, and matters of audit significance related to our report. The audit Principal should document his/her disposition of any advice received from the Annual Audit Practice team prior to recommending signature of the Auditor's Report.

Advice on the Application of Methodology, Guidance and Controls

6.18 The Annual Audit Practice team, under the supervision of the Practice Development Committee, is responsible for the development, implementation and monitoring of the Office policies, methodology and supporting guidance and tools for the annual audits of Crown corporations and other entities. Their application to individual audits requires professional judgement and is the responsibility of the respective audit teams. However, it is anticipated that situations will arise in which additional guidance and advice will be beneficial. Audit teams are encouraged to seek the advice of the Annual Audit Practice team and their colleagues in dealing with difficult audit issues.

Involvement of Specialists — General

6.19 Generally Accepted Auditing Standards (GAAS) require that the auditor and other persons performing the audit should collectively possess adequate knowledge of the subject matter of an audit. In addition, when a specialist is involved, the auditor should consider whether the auditor's involvement in the engagement and knowledge of the subject matter elements involving the specialist is sufficient to enable the auditor to discharge his or her responsibilities. Bringing the appropriate expertise to bear in an audit is essential to developing an appropriate strategic plan, carrying out detailed planning and testing and reporting. The composition of professionals on individual audit teams varies as do the industries in which our clients operate. Accordingly, the need, if any, to involve specialists and the type of specialists will vary considerably from audit to audit and is a matter of professional judgement. The decision as to whether or not to involve specialists in an audit should be made by the audit Principal in consultation with the Director. There are two particular specialists in the Office with whom consultation should be considered for all audits: the Information Technology team, and the Financial Instruments team.

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Information Technology (IT) Audit Specialists

6.20 The IT team provides IT specialists to support annual audits. They are available to assist audit teams in developing strategic plans and in carrying out detailed planning and testing (placing reliance on controls and substantive tests of detail). The ability of audit teams regarding IT skills varies as does the nature of entities' IT systems and control environments. Accordingly, the need for involving IT specialists on individual audits is a matter of professional judgement. The decision as to whether IT expertise is required should be made by the audit Principal in consultation with the Director. As noted in the *Documenting Consultation* section of this Manual, the audit team should document, in the Strategic Plan, its rationale for consulting/not consulting with the Office's Information Technology team.

6.21 IT specialists are normally involved in either the review of work carried out by the audit team or in doing the work. In either case, it is important their work be integrated into the overall audit.

6.22 In strategic planning, the audit team is required to complete a CIS Questionnaire for the purposes of assessing inherent risks related to IT and for determining if a controls reliant approach is appropriate for the audit. The nature and extent of IT involvement would vary according to a number of factors. Factors that would normally suggest IT specialists should be consulted include the following:

- complex CIS systems or environments;
- high reliance on CIS internal audit work;
- significant loss of paper audit trail;
- introduction of major new financial accounting and/or management systems;
- conversion of historical and/or current years' data to a new format; and
- high client expectations.

6.23 In carrying out detailed planning and testing, if a controls reliant approach is adopted, the audit team would consider the need to involve IT specialists. Involvement of IT specialists would be based on similar factors to those identified above. Further, if high reliance on controls is planned for an IT system or an entity has implemented a significant new IT system, these situations would normally require the involvement of IT specialists in carrying out this work. It may also be appropriate to use an IT specialist where the audit team suspects there are control weaknesses in the entity that could affect the audit approach or the information in the financial statements.

6.24 The IT team is also available to support IDEA data extractions for the purposes of carrying substantive tests of detail and/or systems analytics. The IT team can be contacted to provide more information on the use of IDEA.

Financial Instruments (FI) Accounting and Audit Specialists

6.25 Whenever the audit entity is involved with financial instruments (swaps, foreign exchange exposures, derivatives, lending or insurance operations, etc.), it may be appropriate to consult with the FI team. The FI team has the necessary expertise to provide advice with respect to the inherent risks posed by specific financial instruments, the controls that should be in place governing their use, and the appropriateness of the information provided to senior management and the Board. As well, the note disclosure requirements associated with financial instruments are quite complex. Consultation at an early stage may contribute to ensuring that reporting considerations are properly addressed well before the reporting phase of the audit is reached.

6.26 The need for involving FI specialists on individual audits is a matter of professional judgement. The decision as to whether FI expertise is required should be made by the audit Principal in consultation with the Director. As noted in the *Documenting Consultation* section of this Manual, the audit team should document, in the Strategic Plan, its rationale for consulting/not consulting with the Office's FI team.

Legal Services

6.27 Audit Principals should consult Legal Services on matters that present legal risks for the Office. Matters that might require input from Legal Services include situations when:

- potential legal issues are identified by the audit team;
- legal advice forms the basis of a reservation in the auditor's report, for example, relating to non-compliance with authorities or an "other matter";
- advice destined to the Auditor General dealing with legal matters included in an annual audit report, such as a Report Clearance Memorandum;
- substantive discussions are planned with the Department of Justice or the legal services units of an entity;
- a Principal intends to refer in the auditor's report to a legal opinion obtained by the audit entity; and
- requests for new work or services are being considered.

6.28 Further information concerning consultation with Legal Services may be found in the *Practice Expectations Common to All Product Lines* section of this Manual.

Consultation and the Annual Audit of the Public Accounts of Canada

6.29 The annual audit of the Public Accounts of Canada is the largest annual audit in Canada. As might be expected, it has some unique characteristics that

differentiate it from the other annual audits. One of these unique characteristics deals with consultation. Because of the way that the audit is structured, involving entity teams and the Public Accounts team, two types of consultation typically occur:

- between the entity teams and the Public Accounts team; and
- between the Public Accounts team and the other Office specialists.

6.30 The Principal of the Public Accounts team is responsible for the audit of the Public Accounts of Canada and development of the overall audit strategy as set out in the strategic plan for the annual audit of the Summary Financial Statements of the Government of Canada. As well, the Public Accounts team has its own specialists assigned to various aspects of the Public Accounts audit. Accordingly, questions that entity teams would normally direct to specialists in the Office would first be referred to the Public Accounts team Principal (or his/her delegate) for resolution. Depending on the circumstances, the matter may be referred to other specialists on the Public Accounts team or to Office specialists who are independent of the Public Accounts team. In general, entity teams would not refer matters to Office specialists without first discussing them with the Public Accounts team Principal.

6.31 The Public Accounts team may also find it necessary to refer matters to Office specialists. In those cases, the Public Accounts team would be expected to follow Office consultation practices.

The Auditor General's Independent Advisory Committee

6.32 The Independent Advisory Committee (IAC) is a standing committee of external advisors to the Auditor General. The IAC is made up of members of the accounting profession in Canada with senior competence and its purpose is to provide advice to the Auditor General on his annual audits of the Public Accounts of Canada, Crown corporations and other entities. In this respect, the IAC provides advice to the Auditor General on the form and content of his auditor's report on the Public Accounts of Canada (in effect, providing the equivalent of the Annual Audit Practice review) and on the development of Office positions on accounting and financial reporting issues of Office-wide significance. When considered necessary, matters affecting an individual audit of a Crown corporation or other entity may also be referred to the IAC for advice. Finally, the IAC also assists the Auditor General in monitoring developments in the accounting and auditing profession and considering their impact on the work of the Office.

6.33 It is not the responsibility of the IAC to approve materials presented for review. Rather, the purpose of the advice is to ensure that, when the Auditor General takes a position, he is aware of the opinions and views of other knowledgeable individuals in the profession.

6.34 Audit Principals who wish to refer matters to the IAC, should first consult with the Secretary to the IAC.

Documenting Consultation

6.35 Consultation should be properly documented in our audit files. This not only provides evidence that Office policies were complied with, but also provides background information and analysis of issues/options that may have continuing relevance. Proper documentation is also an important principle underlying generally accepted auditing standards. The audit team is responsible for ensuring that the results of consultations have been appropriately documented.

ANNUAL AUDIT POLICY

The audit team should document the results of all significant consultations in the audit working papers.

6.36 There are also two specific situations in which Office policies require documentation of certain decisions made by the audit Principal. These are outlined below:

ANNUAL AUDIT POLICY

The audit team should document, in the Strategic Plan, its rationale for consulting/not consulting with the Office's Financial Instruments and Information Technology teams.

ANNUAL AUDIT POLICY

The audit Principal should document his/her disposition of any advice received from the Annual Audit Practice team prior to recommending signature of the Auditor's Report.

7

Practice Expectations Common to All Product Lines

Introduction

7.1 Although many practices are similar in purpose across product-lines, they often are sufficiently different in application to warrant tailored discussion in each product-line manual. This allows a full description of the audit processes, and facilitates the use of the individual manuals. For example, compliance with authorities is common to all product-lines, but the approach to auditing and the weight given to these matters varies in different types of audits.

7.2 This section describes the practice expectations that are truly common to all product-lines. Many of these expectations are guided by other Office policies, such as the Code of Professional Conduct or the Office Security Policy.

How to use this section

7.3 *Should* statements are expected practices, and require Assistant Auditor General (AAG) approval to override. Expectations derived from other Office policies are linked electronically to the other policy statements.

7.4 This section sets out these common expectations under the following headings:

- **Audit management**
- **People management at the team Level**
- **Continuous improvement**

Audit management

Authority: requests for services or audits

7.5 In recent years, the Office has developed a more interactive relationship with parliamentary committees, audit committees and management in our efforts to promote answerable, honest and productive government. As a result, there have been an increasing number of requests for audits and other services from the Governor in Council, parliamentary committees, audit committees and

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management. While it may be desirable to accommodate these requests, the Office has limited resources. It is important that such work does not negatively impact on our primary mission of carrying out independent audits and examinations for the House of Commons.

7.6 Requests for services or audits need careful consideration as to the appropriateness, legality, and resource implications of such requests.

7.7 Where requests for work are received, audit Principals *should*:

- Obtain the approval of the AAG before making any commitment to the requesting organization;
- Refer requests for work requiring authority under Section 11 of the *Auditor General Act* or under the *Financial Administration Act* to Legal Services; and
- After authorization to accept the request, confirm in writing the terms and conditions of the work to the requesting organization.

Access to Information

7.8 The *Auditor General Act* and the *Financial Administration Act* provide for access to information needed to report, as required by the acts. The acts entitle the Auditor General to free access at all convenient times to this information. The Auditor General is also entitled to receive from members of the public service and Crown corporations, where he is appointed auditor or special examiner, such information, reports and explanations, as the he deems necessary. The Auditor General decides the nature and type of information needed to fulfil the responsibilities set out in legislation. These are very strong provisions, which prevail against all other acts of Parliament, unless they expressly limit access and refer to the appropriate sections of the *Auditor General Act* or *Financial Administration Act*.

7.9 At the same time, however, the Office also has an obligation to ensure that it does not disclose, or act in a manner that unintentionally results in the disclosure of entity information that would not otherwise be accessible.

7.10 **Office requests for Cabinet documents.** Required information may sometimes be contained in Cabinet documents, which are confidences of the Queen's Privy Council of Canada. These documents are classified and are among the most sensitive documents held by the government. They include submissions to and decisions by Cabinet and Cabinet committees, Cabinet agendas and draft legislation. Requests to obtain these documents are handled by the FRL for Access to Information.

7.11 Audit Principals *should* consult with the FRL for Access to Information when requesting Cabinet documents.

7.12 Information requested is to be germane to the fulfilment of audit responsibilities.

7.13 Restrictions to access. Government officials recognize their obligation to co-operate with the Office and normally provide information on request. Staff encountering problems with access *should* not agree to any restrictions on the right to information without consulting the FRL for Access to Information and the AAG/CESD. Denial of access to information constitutes a serious matter that is normally reported to the House of Commons.

7.14 Solicitor/client protected documents. The Office has entered into an agreement with the Department of Justice, as a result of the Professional Institute of the Public Service (PIPS) decision of the Federal Court (Trial Division). The Court decided that because a department had surrendered voluntarily to the Office documents that were solicitor/client protected, the privilege had been automatically waived.

7.15 At the beginning of an audit, the responsible AAG/CESD *should* send a letter to inform the audit entity that disclosure of documents to the Office is in compliance with the *Auditor General Act* and the *Financial Administration Act* and a solicitor/client document given to the Office during an audit does not constitute a waiver by the entity. This will allow the entity to preserve the solicitor/client privilege while meeting the information needs of the Office.

7.16 Information that deals with matters covered by solicitor/client privilege *should* not be divulged without the express consent of the audit entity to waive this privilege.

7.17 Audit information left with the audit entity. The Office of the Auditor General is not subject to the *Access to Information Act*. However, all audit reports, working papers and other information prepared by the Office and left with the audit entity may be subject to disclosure under the Act. These reports and working papers may be requested by third parties, either directly or through access to information requests. We do not normally allow disclosure of this information, other than the information tabled in the House.

7.18 Audit Principals *should* consult with the FRL, Access to Information, before agreeing to the disclosure of non-public audit reports, working papers, and other potentially sensitive information prepared by this Office.

7.19 Further guidance on access to information can be obtained from the FRL, Access to Information.

Security of information

7.20 The Office meets the highest standards of professionalism and integrity and seeks to develop a relationship of respect and trust with those it audits. An important ingredient of those standards and principles is ensuring the security and confidentiality of both client and internal information.

7.21 The Code of Professional Conduct requires that all staff be familiar with the security aspects of their work, accept security as an important individual responsibility, and follow the principles set out in the Security Policy and Guidelines issued by the Office.

7.22 The Security Policy and Guidelines indicate that audit Principals are responsible for:

- acquiring an understanding of the security classification system in their audit entities;
- communicating the requirements to team members; and
- ensuring that the safeguards for the storage of and access to information are equal to or higher than those required by the audit entity.

7.23 If you are using the Office's Intranet site, click on the following icon to view the Security Policy and Guidelines.



Consultation with Legal Services

7.24 Legal Services is responsible for providing legal advice and counsel to the Office. This includes providing advice on:

- legal issues arising in the course of audits;
- the engagement of outside legal counsel; and
- in-house legal issues in areas such as personnel relations, labour relations and contracting.

7.25 Audit Principals *should* consult Legal Services on matters that present legal risks for the Office.

7.26 Matters that might require input from Legal Services include situations when:

- potential legal issues are identified by the audit team early in the audit process;
- legal advice forms the basis of an audit report to be made available outside the Office or where any advice destined to the Auditor General or the Executive Committee deals with legal matters;
- substantive discussions are planned with the Department of Justice or the legal services units of an entity;
- an audit report proposes changes or revisions to legislation, to ensure that it is appropriate and consistent with previous recommendations made by the Office;
- a Principal intends to refer in an audit report to a legal opinion obtained by the audit entity;
- requests for new work or services are considered; and
- third party references are made in reports.

7.27 Before making any reference in audit reports to a legal opinion, audit Principals *should* draw the matter to the attention of the Deputy Minister or the equivalent level in the audited entity and send a copy of the pertinent sections of the report to the client's legal services unit, and seek a waiver to the privilege.

Under revision

Legislative amendments

7.28 (Legal Services is considering proposed wording for this section.)

Co-ordination of work with regional offices

7.29 Many entities have highly decentralized operations in order to provide services to the various regions of the country. The Office has established regional Offices to ensure a first-hand knowledge of the decentralized operations, a relationship of respect and trust with regional entity management and the most cost-effective use of resources.

7.30 Both the entity and regional Principals *should* ensure high levels of co-operation, co-ordination and liaison between regional and entity teams. This can include situations involving the regional office in entity planning, designating regional staff as liaison with an audit entity, promoting two-way communication on emerging audit issues, giving early notice of planned field trips, and utilizing regional staff, when dealing with matters located in the regions.

Under revision

Conflict of interest, fraud or other illegal acts

7.31 (The Executive Committee is considering proposed wording for this section)

Carrying out surveys

7.32 Surveys are increasingly becoming part of the auditors tool kit, particularly in the case of VFM audits and studies. Surveys are used to ask individuals about factual situations, their views and perceptions and their actual behavior. As well, survey methods can be used to enhance other audit techniques. The Office defines a survey as the administration of a standardized procedure, such as a questionnaire or a structured interview to obtain information on 25 or more individual cases, with the intention of making aggregated statements about the matters surveyed.

7.33 Audit Principals *should* consult with the FRL, Surveys in planning survey-related activities. If you are using the Office's Intranet site, click on the following icon to view the Guide on Conducting Surveys.



**Functional Guidance
Shell**

Audit notes

7.34 Audit notes are an important part of the Auditor General's report. The audit notes chapter represents an alternative reporting mechanism for matters of significance that come to the attention of audit teams. Audit notes may be identified during any of the various types of audit work carried out by the Office. The audit notes chapter author is responsible for producing the chapter and for supporting the work of the Audit Notes Committee. The Committee is chaired by an AAG.

7.35 The Audit Notes Committee's role is to:

- provide overall direction for the preparation and submission of proposed notes;
- support the activities that contribute to the production of the chapter; and
- review and approve notes for inclusion in the chapter.

7.36 Audit teams are to be alert to the possibility of potentially significant issues and devote appropriate effort to investigate such matters. When developing and reporting audit notes, audit teams *should* comply with the Value-for-Money Audit Standards, except those requiring the setting of overall audit objectives, recommending corrective measures, and concluding against audit objectives.

7.37 The Audit Notes Committee sends out annual guidelines requesting the submission of audit notes, establishing a timetable for submissions and providing general direction.

7.38 If you are using the Office's Intranet site, click on the following icon to view the most recent audit notes guidelines.

(DATABASE CURRENTLY UNDER CONSTRUCTION)

Restrictions in public reporting

7.39 The *Auditor General Act* requires the Auditor General to "call attention to anything that he considers to be of significance and of a nature that should be brought to the attention of the House of Commons." Classified information may be critical for developing and supporting certain audit observations. In these circumstances, audit entities may express concern that such information, included in audit reports or other communications with the public, may be harmful to the national interest, and may request that it not be disclosed.

7.40 Audit Principals *should* assess with their AAGs whether requests to restrict reporting are valid, and seek the authority of the DAG/CESD or Auditor General before agreeing to remove significant material from the report on the basis that it might be harmful to the national interest.

Reports to entity management

7.41 During the course of an audit, the audit team may identify situations, including weaknesses in controls, opportunities for improvement, deficiencies, or work well done that are not significant or of a nature to warrant reporting to Parliament or to the Boards of Directors of Crown corporations. However, the observations may be useful to entity management. Auditors may communicate these observations, either orally or in writing, to the appropriate level of entity management. Written audit reports or other written forms of communication that are left with the entity are subject to access to information in the entity. Reports to entity management *should* be approved by the entity principal; reviewed by the AAG/CESD; discussed with entity management; communicated clearly; and issued on a timely basis.

Under revision

Third party clearances

7.42 (Legal Services is considering proposed wording for this section).

External communications

7.43 It is expected that all Office communications with Parliament and other stakeholders are clear, persuasive and effective. Other key expectations are explained in the following paragraphs.

7.44 **Testimony at standing committee hearings.** Once the reports of the Auditor General and the Commissioner of the Environment and Sustainable Development are tabled in the House of Commons, they are referred to the Standing Committee on Public Accounts or the Standing Committee on the Environment and Sustainable Development. Committees consider the reports and examine certain matters contained in the reports at committee hearings. The committees frequently call members from the audited entity to testify. The Auditor General/CESD and members of his staff are also present and may be required to make an opening statement about the audit issues and to respond to questions from members. More frequently, these and other standing committees are requesting the Office to appear before the Committee to discuss and answer questions about audit reports.

7.45 The Office has been encouraging AAGs/Principals to spend more time with committee staff in order to obtain a better understanding of concerns and interests of the Committee and to explain the role of the Office and the value of using Office products. How the committees deal with an audit observation can have an important impact on the corrective actions taken by the audited entity.

7.46 **Public communications.** The Director, Communications is responsible for co-ordinating public communications activities, including responding to media and public inquiries. Public communications includes any matter imparting knowledge that could only have been acquired while working for the Office of the Auditor General.

7.47 **Spokespersons for the Office.** On tabling day of his report and during the following week, the Auditor General is the only spokesperson for the Office

unless otherwise approved. At other times, the Auditor General may designate other staff members to respond “on the record” to the media about audits under their direction. A list of these designates will be published before each tabling. Similarly, the Commissioner of Environment and Sustainable Development is the only spokesperson for the Office on tabling day of his report and during the following week. At other times, the CESD may designate other staff members to respond “on the record” to the media for material within his report. Designated staff members who are contacted by the media for background information on their chapter inform the Director, Communications once they have responded.

7.48 Requests for interviews with media representatives *should* be channelled through the Director, Communications.

7.49 **Other public communications.** Office staff members are in a unique position of having access to information and insight into government operations. As a result, they are often asked for their views on matters that are both work-related and non-work-related. Staff *should*:

- inform their Principal or a higher level person to whom they report if they intend to deal with the media on a non-work-related topic and might be identified as an employee of the Office.
- obtain the approval of the AAG/CESD before accepting invitations to speak, teach, or lecture on work-related topics.
- obtain the authorization of AAG/CESD, in consultation with the Director, Communications, to publish work-related articles, and include in the article a disclaimer that the views expressed do not necessarily represent the views of the Office.

7.50 **Serving on professional practice committees.** Members of the Office often serve on committees of professional or international organizations that are involved in standards or audit practice development initiatives. Although officially they may be serving in a personal capacity, there is an obligation to not only present their personal point of view but also the Office position.

7.51 Members of the Office serving on outside committees involved in standard or audit practice development *should*:

- inform themselves of the Office position on issues they deal with at external committees, by consulting with the appropriate members of the Office, including FRLs;
- notify the Practice Development Committee (PDC) chair of any significant variances of positions taken by the committee with those of the Office; and
- inform the PDC about substantive issues arising from committees that relate to and have a significant impact on Office methodology and practice.

7.52 **Preparation for tabling and standing committee hearings.** Parliamentary Liaison is responsible for co-ordinating effective Office

participation at committee hearings. This includes arranging and co-ordinating the preparation for scheduled hearings; briefing meetings, as required, with members of the Office staff, committee staff and committee members; and post-meeting reviews to identify opportunities for future improvements.

7.53 The External Policy on Communications and the Guidelines for Hearings and Auditor General Briefings describe practice expectations in these areas.

7.54 If you are using the Office's Intranet site, click on the following icons to view the Policy or Guidelines.



**Ext./Int.
Communications Policy**



Parliament Shell

People management at the team level

7.55 In the Strategic Framework, the Office sets out its vision and mission and its commitment to the highest standards of professionalism and integrity. The Office wants to create a work environment where employees can take pride in the Office and its products and feel responsible for its success.

7.56 The Office values its employees and recognizes that they are the most important element in meeting its goals. The aim is to have a respectful workplace that develops highly skilled, motivated, and productive individuals, while maintaining the flexibility and diversity required to achieve the mission in a cost-effective manner. Audit teams are where the majority of the Office resources are used and are the front lines in terms of operations. It is important that teams operate in an environment that encourages personal growth and fulfilment of aspirations.

7.57 The Office is engaged in a fundamental review of the roles and responsibilities of all supervisors including DAGs, AAGs, Principals, Directors and team supervisors. When this review is completed, the results will be incorporated into this manual.

7.58 To ensure that we live up to our commitment to our people, the Office has established a number of expectations to govern the way we manage people at the team level. Persons supervising others are expected to:

- be role models in action and in words and consistently practice sound leadership;
- exhibit and encourage openness, patience, trust and teamwork;
- clearly define the work assigned, the purpose of the work, and employees' functions, responsibilities and authority, and explain how the assigned work fits into and contributes to the accomplishment of the overall objectives of the audit;
- coach staff to achieve higher performance. Coaching involves ensuring that expectations are clearly set out, transferring skills to staff, working with people having problems, providing skill and development opportunities, following up and providing feedback, recognizing good performance, and giving encouragement;
- maintain both formal and informal channels of communication to keep staff informed about the Office vision, mission, priorities, quality management system, Office and team quality improvement initiatives; new or innovative audit practices; and other issues affecting the individual, team, or Office as a whole;
- ensure that any barriers between audit teams and functions are reduced and promote teamwork and open communications up, down and across the organization;
- involve team members, whenever practical, in solving problems and in initiatives to improve quality and encourage them to suggest innovative ideas; and
- identify individual and team training and development needs and respond to these needs through training, work assignments and counselling on performance progress.

7.59 If you are using the Office's Intranet site, click on the following icon to view the Human Resources Information Site (HRIS). HRIS provides a complete description of people management expectations.



**HRIS Human
Resources Information**

Continuous improvement

Under revision

7.60 Quality is a basic operating principle of the Office. Quality involves every aspect of the Office's operations including its leadership, the focus on client needs, management of our people, audit practices and other processes, and our system for measuring performance. Quality is not a static condition. It requires a commitment from every staff member to continuous improvement.

7.61 A critical feature of the quality management system is the process for measuring, in a comprehensive way, how well we're doing in achieving our goals. This is achieved through a variety of review mechanisms.

The review continuum

7.62 Review is carried out in several ways, but all based on the audit standards, quality control criteria, Office policies and other practice expectations in place within the Office. All levels of review are designed to provide assurance that practices meet accepted standards, and to help the Office continuously improve the quality of its products.

7.63 Team self-assessment. Audit teams can review audit practices through post-audit discussions and using available Self-Assessment Checklists. Checklists act as reminders to support the team in producing a high-quality audit. They can provide a blueprint for corrective actions during the course of the audit, provide a barometer to measure the quality of the audit, expedite future internal practice and external reviews, and identify opportunities to improve team and Office practices.

7.64 Practice reviews. The Professional, Practice and Review Group carries out practice reviews of a sampling of audits in order to obtain a perspective on the quality of audit and management practices. It also carries out reviews of areas of higher risks across all audits. The scope of the practice reviews encompasses all aspects of the audit process. Practice reviews are designed to contribute to continuous improvement by creating the opportunity for audit teams and the Office to learn from experience.

7.65 If you are using the Office's Intranet site, click on the following icon to view the Policy on Practice Review for annual audits.



Policy.rtf

7.66 Internal audit. Internal audits of administrative functions are carried out using the same auditing standards that the Office uses when conducting audits in the government. Internal Audit advises management of significant risk areas within the Office and the extent to which they are being well managed. It provides information, analysis, assessments and recommendations to assist management in the discharge of its responsibilities.

7.67 External reviews. The Office periodically appoints an external organization to carry out a review of its practices in order to confirm internal assessments and to obtain a truly independent assessment.

Under revision

8

Quality Management System (QMS)

Elements of Our Quality Management System (QMS)

8.1 The Office established the elements of its *Quality Management System (QMS)* based on existing standards of the American Institute of Certified Public Accountants, guidance for developing Quality Control Systems in Public Accounting published by the CICA (1993), input from a major public accounting firm regarding “best” practices in managing quality of annual audits, and input and advice from its senior annual audit practitioners. The *QMS* is made up of the following elements:

- **Audit Management** — The steps that must be undertaken to conduct a quality audit in accordance with generally accepted auditing standards, applicable legislation and Office policies, practices and procedures;
- **People Management** — The way in which we help staff achieve our goal of conducting quality audits, developing their full potential as professionals and contributing towards developing a highly motivated audit organization;
- **Continuous Improvement** — The creation of an audit culture that constantly seeks to improve itself and provide more value added to Canadians and our audit entities.

8.2 These elements, their related criteria and key instruments employed in the *QMS*, as it applies to our annual audit practice, are described in table at the end of this section.

Reasonable Assurance

8.3 The Office’s Quality Management System is designed to provide “reasonable” assurance, in light of the likelihood and magnitude of potential risks, that it conducts annual audits in accordance with applicable legislative requirements, professional standards and Office policies. Reasonable assurance recognizes that the cost of managing risks should not exceed the benefits likely to be derived.

8.4 As such, reasonable assurance involves a satisfactory level of confidence under given considerations of cost, benefits and risks — it does not mean absolute assurance of all aspects of quality for each individual audit.

Ongoing Improvement of the Quality Management System

8.5 Continuous improvement activities are part of every quality management system. A continuous improvement process will ensure that our quality management system continues to evolve to reflect the current environment within which the Office operates.

8.6 A continuous improvement process typically contains six activities that operate in an interactive manner: various forms of review to assess product or process quality; identification and documentation of lessons learned; development of an inventory of improvement initiatives; practice improvement studies to propose reinforcements to approaches; formal documentation of standards and expected practices; and development initiatives to build staff awareness of new standards and expectations. These activities apply equally to all elements of the Office's *Quality Management System*.

Key Elements of the Annual Audit Practice Quality Management System

Quality Management Element	This element of the Office's Quality Management System should provide reasonable assurance that	Key Instruments Employed
Audit Management		
1. Authority	The Office only undertakes audits where it has the authority to do so and, in those limited circumstances in which the Office can exercise discretion in accepting an engagement, they pose no undue risk to the Office.	• Auditor General Act • Financial Administration Act and Entity Specific Legislation • Annual Audit policies and guidance • Legal Services team advice and support
2. Independence, objectivity and integrity	Personnel are free of any obligation or interest in their audit entities; personnel are honest and candid at all times with due regard for confidentiality of the audit entities' affairs; and personnel maintain an impartial state of mind when carrying out audits.	• Auditor General Act • Office Code of Conduct • Annual Audit policies and guidance • Conflict of interest declarations/re-certification and related guidance • Legal Services team advice and support • TB Conflict of Interest and Post Employment Code for the Public Service

3. Conduct of the audit	The Office has in place an appropriate audit methodology, recommended procedures and practice aids which are intended to result in efficient audit approaches that produce sufficient, appropriate audit evidence at the appropriate time in order to allow the Office to meet its reporting responsibilities. Communication of matters of significance takes place throughout the audit process between audit teams and management of the audit entities.	• Annual Audit policies and guidance Office • Methodology for Annual Audits (Guide 25) • Predetermined Audit Documentation (PADs) • Software support tools (APEX, PW Controls and IDEA) • Functional Responsibility Leader for the Annual Audit Practice to provide advice • Methodology review and update mechanisms for Annual Audit policies, methodology and guidance
4. Consultation	When dealing with complex, unusual or unfamiliar issues, audit teams refer to authoritative literature and seek the assistance of Office specialists and/or individuals from outside the Office with appropriate competence, judgement, and authority.	• Annual Audit policies and guidance • Financial Instruments, Information Technology and Legal Services teams to provide advice and support • Centralized financial statement review function • Independent Advisory Committee • Predetermined Audit Documentation (PADs) and library resources including electronic databases
5. Security, access, and file retention	Personnel have security clearance appropriate for the nature of documentation that they will be required to access; there are appropriate restrictions on the access to audit files (electronic and hard copy) and related audit reports; and audit files are retained for an appropriate length of time.	• Annual Audit policies and guidance • Security policies and guidance • Security review and update mechanisms • Security Officer in place • Security clearance procedures

People Management		
6. Resourcing	Audit teams possess the required qualifications and competencies to enable them to carry out audits. Personnel assigned to specific engagements have the appropriate degree of technical training and proficiency to carry out the work.	• Annual Audit policies and guidance • Human Resources policies and guidance • Annual Audit Scheduling Coordinators • Centralized Human Resource function
7. Leadership and supervision	Managers provide an appropriate level of leadership and direction and foster an environment in which all team members are encouraged to perform to their potential and to ensure that audits are properly carried out. Personnel are properly supervised and coached in their work.	• Annual Audit policies and guidance • Human Resources policies and guidance • Office Mentoring Program
8. Performance management	Personnel receive timely and constructive feedback on their performance. Personnel have access to counseling, guidance and monitoring to help them manage and develop their careers. Personnel selected for advancement are competent and fully qualified to fulfil the responsibilities that they will be called upon to assume.	• Annual Audit policies and guidance • Human Resources policies and guidance • Centralized Human Resource function • Performance Management System including assignment and annual objectives and appraisals • Counseling, guidance and monitoring processes • Promotion processes
9. Professional development	Personnel undertake professional development through such means as on-the-job training, formal courses, self-directed studies, and internal and external assignments.	• Human Resources policies and guidance • Centralized Professional Development function • Professional development through such means as on-the-job training, annual staff updates, formal courses, self-directed studies, and internal and external assignments • Library resources • Self-Learning Center • Counseling, guidance and monitoring processes

3. Conduct of the audit	The Office has in place an appropriate audit methodology, recommended procedures and practice aids which are intended to result in efficient audit approaches that produce sufficient, appropriate audit evidence at the appropriate time in order to allow the Office to meet its reporting responsibilities. Communication of matters of significance takes place throughout the audit process between audit teams and management of the audit entities.	• Annual Audit policies and guidance Office • Methodology for Annual Audits (Guide 25) • Predetermined Audit Documentation (PADs) • Software support tools (APEX, PW Controls and IDEA) • Functional Responsibility Leader for the Annual Audit Practice to provide advice • Methodology review and update mechanisms for Annual Audit policies, methodology and guidance
4. Consultation	When dealing with complex, unusual or unfamiliar issues, audit teams refer to authoritative literature and seek the assistance of Office specialists and/or individuals from outside the Office with appropriate competence, judgement, and authority.	• Annual Audit policies and guidance • Financial Instruments, Information Technology and Legal Services teams to provide advice and support • Centralized financial statement review function • Independent Advisory Committee • Predetermined Audit Documentation (PADs) and library resources including electronic databases
5. Security, access, and file retention	Personnel have security clearance appropriate for the nature of documentation that they will be required to access; there are appropriate restrictions on the access to audit files (electronic and hard copy) and related audit reports; and audit files are retained for an appropriate length of time.	• Annual Audit policies and guidance • Security policies and guidance • Security review and update mechanisms • Security Officer in place • Security clearance procedures

People Management		
6. Resourcing	Audit teams possess the required qualifications and competencies to enable them to carry out audits. Personnel assigned to specific engagements have the appropriate degree of technical training and proficiency to carry out the work.	• Annual Audit policies and guidance • Human Resources policies and guidance • Annual Audit Scheduling Co-ordinators • Centralized Human Resource function
7. Leadership and supervision	Managers provide an appropriate level of leadership and direction and foster an environment in which all team members are encouraged to perform to their potential and to ensure that audits are properly carried out. Personnel are properly supervised and coached in their work.	• Annual Audit policies and guidance • Human Resources policies and guidance • Office Mentoring Program
8. Performance management	Personnel receive timely and constructive feedback on their performance. Personnel have access to counseling, guidance and monitoring to help them manage and develop their careers. Personnel selected for advancement are competent and fully qualified to fulfil the responsibilities that they will be called upon to assume.	• Annual Audit policies and guidance • Human Resources policies and guidance • Centralized Human Resource function • Performance Management System including assignment and annual objectives and appraisals • Counseling, guidance and monitoring processes • Promotion processes
9. Professional development	Personnel undertake professional development through such means as on-the-job training, formal courses, self-directed studies, and internal and external assignments.	• Human Resources policies and guidance • Centralized Professional Development function • Professional development through such means as on-the-job training, annual staff updates, formal courses, self-directed studies, and internal and external assignments • Library resources • Self-Learning Center • Counseling, guidance and monitoring processes

10. Respectful workplace	Personnel demonstrate and encourage in others those behaviours that lead to a respectful workplace which develops highly skilled, motivated and productive people who contribute to fulfilling the mission of the Office. Personnel respect and value diversity in the Office.	• Human Resources policies and guidance including Discrimination and Harassment Policy and Health and Safety Policy • Centralized Human Resource function • <i>Official Languages Act</i> and <i>Employment Equity Act</i> • Justice Canada mediation program • Harassment coordinators
Continuous Improvement		
11. Practice review	The Office carries out internal reviews of its Annual Audit Practice to assess the extent to which its practice meets these Quality Management Criteria for the Annual Audit Practice.	• Practice review policy and program • Internal audit